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In the published version of this decision, some information has been omitted, pursuant to articles 24 and 25 of Council Regulation (EC) No 659/1999 of 22 March 1999 laying down detailed rules for the application of Article 93 of the EC Treaty, concerning non-disclosure of information covered by professional secrecy. The omissions are shown thus […].		PUBLIC VERSION This document is made available for information purposes only.

Subject: State aid SA.35040 (2012/N) –Bulgaria
JESSICA Holding Fund Bulgaria

Sir,

The Commission wishes to inform you that it has decided not to raise objections to the above-mentioned case for the reasons set out below.

1. PROCEDURE

(1) Following a pre-notification procedure under PN SA.34274 - 2012/PN, by letter of 26 June 2012, the Bulgarian authorities notified the above-mentioned measure pursuant to Article 107(3) of the Treaty on the Functioning of the European Union (TFEU).

(2) A number of informal exchanges of information with the Bulgarian authorities took place during the pre-notification phase. A meeting between the Bulgarian authorities, representatives of the European Investment Bank and Commission services took place on 22 March 2012. Following the measure's notification, the Commission services requested further information by letters of the 10 August 2012 and the 5 November 2011. The Bulgarian authorities answered by letters dated respectively 30 August 2012 and 21 November 2011. Bulgaria accepts that the present decision be adopted in the English language.

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2. DESCRIPTION OF THE MEASURE

2.1. Structure and Objective

2.1.1. Facilitating sustainable urban development by provision of sub-commercial conditions via Urban Development Funds to private investors

(3) The notified measure consists in an aid scheme making use of financial engineering instruments such as provision of equity, loans and guarantees at sub-commercial terms to private investors that carry out sustainable urban development projects. Aid is granted from the Operational Programme for Bulgaria "Regional Development" 2007-2013[1] (OPRD) by means of two Urban Development Funds (UDF), the first UDF, hereinafter referred to as UDF 1, being responsible for projects in the city of Sofia and the second UDF, hereinafter referred to as UDF 2, being responsible for projects in the other six biggest Bulgarian cities: Plodiv, Varna, Burgas, Ruse, Stara Zagora and Pleven.

(4) The UDFs act under the umbrella of the JESSICA Holding Fund Bulgaria (JHFB). The funds' legal obligations result from the Funding Agreement between the JHFB and the Bulgarian authorities[2] and from the two Operational Agreements between the JHFB and the UDFs,[3] which are part of the notification.

(5) The notified scheme seeks to facilitate sustainable urban development in urban regions of Bulgaria by fostering private investment in projects that contribute to sustainable urban development. It will ultimately result in greater market efficiency and social cohesion.

(6) The notified scheme is part of the Joint European Support for Sustainable Investment in City Areas (JESSICA) initiative, a policy initiative of the European Commission supported by the European Investment Bank (EIB) in cooperation with the Council of Europe Development Bank. JESSICA is designed to help Member States in using financial engineering mechanisms to support investment in sustainable urban development in the context of EU cohesion policy in the programming period 2007-2013.[4]

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1 http://ec.europa.eu/regional_policy/country/prordn/details_new.cfm?gv_PAY=BG&gv_reg=ALL&gv_PGM=1061&gv_defL=4&LAN=7

2 Funding Agreement between the European Investment Bank (acting as the Holding Fund) and the Government of Republic of Bulgaria, signed 29 July 2010.

3 Operational Agreement between the European Investment Bank, the Fund for Sustainable Urban Development of Sofia EAD and the Fund for Local Authorities and Governments – FLAG EAD signed on 30 May 2012 (UDF 1) and the Operational Agreement between the European Investment Bank, the Regional Urban Development Fund AD (*Aktzionerno Druzhestvo* is a corporate legal form under the Bulgarian Trade Act equivalent to a joint-stock company.), Société Générale Expressbank AD, Elana Holding AD, Elana Investment AD and Balkan Advisors AD, signed on 27 and 28 December 2011 (UDF 2).

4 See Article 44 of Council Regulation (EC) No 1083/2006 of 11 July 2006, laying down general provisions on the European Regional Development Fund, the European Social Fund and the Cohesion Fund and repealing Regulation (EC) No 1260/1999, OJ L 210 of 31.7.2006, p. 25, hereafter referred to as the "General Regulation";
Articles 3(2)(c), 4(1), 5(1)(d) and 6(2)(a) of Regulation (EC) No 1080/2006 of the European Parliament and of the Council of 5 July 2006 on the European Regional Development Fund repealing Regulation (EC) No 1783/1999, OJ L 210 of 31.7. 2006, p. 1, hereafter referred to as the "ERDF Regulation",

(7) JESSICA has been set up as a response to perceived market failures in the urban development funding environment, the lack of an integrated urban development approach, a funding deficit necessitating greater leverage of scarce public resources and, overall, the need for a more commercial approach to the regeneration of urban areas.

(8) The essence of JESSICA is to use the Structural Funds' resources and national match-funding to support Urban Development Projects (UDPs) that have a potential to contribute to sustainable urban development, but have an Internal Rate of Return (IRR) that is not sufficient to attract financing on a purely commercial basis. That support takes the form of repayable investments at sub-commercial terms.

(9) The JESSICA mechanism aims at enabling public resources to be invested in a repayable way and thus to be "recycled" and become available for further reinvestment in UDPs. JESSICA is therefore an alternative mechanism to the traditional use of Structural Funds as non-repayable, one-off grants. It aims at the same time to be less distortive to competition than such grants.

(10) JESSICA was launched with a view to providing new opportunities and instruments to Member State for the European Regional Development Fund (ERDF) programming period 2007-2013 by the following means:

(a) Ensuring long-term sustainability through the revolving character of the Structural Funds' contribution to specialised funds investing in UDPs;

(b) Creating stronger incentives for successful implementation of UDPs by beneficiaries, by combining grants with loans and other financial instruments;

(c) Leveraging additional resources for UDPs with a focus on their sustainability/recyclability in the regions of the EU; and

(d) Contributing financial and managerial market expertise from specialists to UDPs.

2.1.2. Addressing well-defined objectives of common European interest

(11) In its notification, Bulgaria points out that the measure addresses a well-defined objective of common European interest in accordance with the following provisions:

(12) Under the SF Regulations in the programming period 2007-2013[5], managing authorities in Member States are allowed to use financial engineering mechanisms in order to invest part of their Structural Funds' allocations to catalyse investment in UDPs.

(13) Under the Convergence Objective (Article 4 of the ERDF Regulation), the ERDF focuses its assistance on supporting sustainable integrated regional and local economic

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Article 11(1) of Regulation (EC) No 1081/2006 of the European Parliament and of the Council of 5 July 2006 on the European Social Fund and repealing Regulation (EC) No 1784/1999, OJ 210 of 31.7.2006, p. 12, hereafter referred to as the "ESF Regulation"; and
Articles 43 to 46 of Commission Regulation (EC) No 1828/2006 of 8 December 2006 setting out rules for the implementation of Council Regulation (EC) No 1083/2006 laying down general provisions on the European Regional Development Fund, the European Social Fund and the Cohesion Fund and of Regulation (EC) No 1080/2006 of the European Parliament and of the Council on the European Regional Development Fund OJ L 371 of 27.12.2006 p. 1., hereafter referred to as the "Implementing Regulation".
Throughout this decision those regulations will be referred to collectively as the "SF Regulations".

[5] See footnote 4.

development and employment, where urban areas are equally eligible for benefiting from that type of investment.

(14) Under the Regional Competitiveness and Employment Objective (Article 5 of the ERDF Regulation), the ERDF focuses its assistance on the following three priorities:

(a) Innovation and the knowledge economy, including promoting innovation and entrepreneurship by supporting business networks and clusters in all sectors of the regional and local economy;

(b) Environment, and in particular promoting investment for the rehabilitation of the environment, including contaminated, abandoned and other brownfield sites and land, promoting energy efficiency and renewable energy production;

(c) Access to transport and telecommunication services of general economic interest, including the establishment of public internet access points.

(15) Article 8 of the ERDF Regulation focuses specifically on sustainable urban development, and states that "in the case of action involving sustainable urban development as referred to in Article 37(4)(a) of Regulation (EC) No 1083/2006, the ERDF may, where appropriate, support the development of participative, integrated and sustainable strategies to tackle the high concentration of economic, environmental and social problems affecting urban areas."

(16) That provision also states: "These strategies shall promote sustainable urban development through activities such as: strengthening economic growth, the rehabilitation of the physical environment, brownfield redevelopment, the preservation and development of natural and cultural heritage, the promotion of entrepreneurship, local employment and community development, and the provision of services to the population taking account of changing demographic structures."

2.1.3. Providing an integrated approach by the use of Integrated Plans for Sustainable Urban Development (IPSUDs)

(17) In order to achieve sustainable urban development, the notified measure foresees a holistic approach composed of social, economic and environmental elements that are reflected in the Funding Agreement for the JHFB as well as the Operational Agreements between the JHFB and the two UDF managing institutions mentioned in recitals (3) and (4). In addition, the measure will be in line with the integrated planning included in the Operational Programme "Regional Development" 2007-2013 for Bulgaria. These documents will thus provide the basis for ensuring the overarching integrated approach for sustainable urban development.

(18) In accordance with the SF Regulations, the JHFB has to operate on the basis of the overarching planning mentioned above that is complemented by specific local IPSUDs.

(19) The Bulgarian authorities, taking account of Article 8 of the ERDF Regulation, as well as of Section 2.1 of the Community Strategic Guidelines on Cohesion 2007-2013[6] informed the Commission that in the context of the notified measure, local IPSUDs

[6] Council Decision of 6 October 2006 on Community strategic guidelines on cohesion (2006/702/EC), OJ L 291, 21.10.2006, p. 11.

which correspond to urban planning measures under applicable Bulgarian urban development laws, shall furthermore have to meet the following main requirements:

(a) Any IPSUD must be officially proposed and certified by the relevant local authority or public sector agency on the basis of existing legislation on land use planning.

(b) IPSUDs must indicate a geographical area of intervention precisely defined.

(c) IPSUDs have to be based on a clear strategy, justifying the need for public intervention.

(d) IPSUDs shall contain the elements of a land-use plan, i.e. sufficient physical definition of any public works to be undertaken, specification of standard land-use parameters, the minimum level of public services required and the associated infrastructure endowment have to be established.

(e) Integration into a wider area must be insured for any IPSUD.

(f) IPSUDs must entail corrective measures from applicable environmental impact assessment procedures under EU law.

(g) A study of the needs and a socio-economic appraisal has to be carried out for each IPSUD.

(h) In each IPSUD, a governance scheme setting up a clear timetable and responsibilities has to be present.

(i) Financial analysis and a well-defined funding structure ensuring its implementation and long-term financial sustainability is necessary for every IPSUD.

(20) The Bulgarian authorities confirmed that the integrated planning documents mentioned above shall be in line with the criteria set out in the Community Strategic Guidelines on Cohesion 2007-2013.[7]

2.1.4. Alternative approaches to address the objective

(21) The Bulgarian authorities informed the Commission that prior to their notification they introduced other measures in order to address urban development needs, notably various grant schemes under the Operational Programme "Regional Development" 2007-2013 providing subsidies to urban authorities to finance urban regeneration. Those alternative measures are not part of the notification and are therefore not affected by the present decision.

2.1.5. Efficiency objective: Addressing Market failure(s)

(22) Addressing the above-mentioned urban development needs requires substantial capital investments. However, according to Bulgarian authorities, those investments would not be delivered by the market even though it could be efficient from a wider economic perspective, thus constituting a market failure both on the demand and supply side.

(23) The Bulgarian authorities provided information, including a horizontal study of the JESSICA Bulgaria scheme[8], stating the existence of market failures. Those failures

[7] Article 8 of the ERDF Regulation and Section 2.1 of the Annex to Council Decision 2006/702/EC.

[8] JESSICA in-depth economic assessment of the compatibility of State Aid under the JESSICA Bulgaria scheme, Horizontal Study Concept Paper, 2 December 2011.

mostly fall into the categories of (i) information failures (imperfect information and information asymmetries (ii) externalities (iii) coordination problems and (iv) risk aversion. In addition, Bulgaria committed to verify the existence of a case-specific market failure whenever claimed in a UDP application for funding (see section 2.7.5.3 below).

(24) In their notification the Bulgarian authorities made reference to a number of market failures both on the demand and on the supply side, and which are specifically linked to the urban development objectives supported by the JHFB's investment strategy (see section 2.5.2 below).

2.1.5.1. Information failures (imperfect information/information asymmetries)

(25) Imperfect information exists where it is difficult or expensive to gain detailed information on demand either because markets are weak or because information is expensive (or in some cases impossible) to collect. Information is not only imperfect but can also be asymmetric, where market counter-parties possess different levels and depth of information about local markets in general and specific developments in particular. Informational asymmetries reflect the high and uncertain risks attributed to urban development actions by developers and investors.

(26) This increases risk aversion among investors and results in overly conservative projections of the value of new developments, which often means that investors perceive development to be economically unviable. Uncertainty and perceptions of high investment risk from both developer and funder perspectives may either be priced into projects or lead to a decision not to invest/develop. Thus, the market often perceives high and unacceptable market risks, especially until completion and the confirmation of first results, and does not take the projects forward, even though this would be efficient from a wider economic perspective.

(27) Information failures as a rule lead to high transaction and agency costs where it is time-consuming and expensive to gain full and robust information about the specific site and the urban project as a whole. Potential investors face more difficulties in gathering reliable information on the business prospects of an urban regeneration project. This is in particular the case for high risk projects. Furthermore, small deals are less attractive to investment funds due to relatively high costs for investment appraisal and other transaction costs.

(28) With regard to the urban regeneration process, the Bulgarian authorities identified the following information failures:

(a) Difficulties to establish project cash flows due to long payback period and lack of comparative information on similar investments. Additional uncertainties about future returns may be related to estimation of future demand, pricing levels in cases where these are subjected to regulatory control, possible obligation to internalize costs of adjacent public infrastructure, etc.

(b) Urban development projects usually involve significant upfront preparatory costs and lengthy pre-construction and construction periods. They bring significant time lags before the value can be realized for investors. This leads to either reluctance of market participants to get involved in project preparation at all or to pricing higher associated risks into the cost of investment. As a result, projects which provide higher short-term returns are preferred to longer-term urban infrastructure projects, leading to under-investment at higher capital costs.

(c) Urban regeneration is associated in many cases (e.g. in brownfield development) with the need to address contamination, dereliction and site assembly or remediation issues, the level of which and related costs being often uncertain or unknown. These risks are often priced into the project.

(d) Uncertainties, resulting in inappropriate levels of investment risk being attributed to particular urban developments, could also be based on the spatial characteristics of sites. The latter could be subject to constraints arising from the existing spatial planning or socio-economic characteristics of the particular location (i.e. a deprived urban area characterized by a low-income population, high unemployment and social exclusion), leading to higher development costs and uncertainty of demand and revenues.

(e) The characteristics of urban regeneration projects result in information failures related to their valuation, i.e. their market price over time. This is further aggravated by the lack of long-term functioning of the urban real estate market in Bulgaria, which started to develop on market economy terms only in the last two decades. This, again, leads to perception of higher investment risk.

(29) The above-mentioned information failures related to urban development actions are, largely, common for all EU countries. There are a few other information failures specific for Bulgaria, arising from underdeveloped urban development and financial markets:

(a) As demonstrated by recent studies[9], Bulgarian local authorities (municipalities) which are in theory expected to be a major sponsor/developer of revenue-generating urban development projects, still do not have the capacity to leave the well-known grounds of grant financing and start thinking entrepreneurially. They have a preference for non-revenue generating projects and view themselves more as aid recipients rather than investors in urban regeneration. To some extent this is due to a lack of awareness and practical knowledge of local authorities that urban development could be implemented in a sustainable manner, as policy goals can be achieved by economic means through the market interaction of private developers and finance providers which the local authorities should initiate and incentivize.

(b) According to the Bulgarian authorities, the private urban property regeneration market is just emerging in Bulgaria and is still in its embryonic stage. This results, inter alia, in a lack of reliable information of fair market value of urban regeneration property, but also in a lack of an authentic mechanism to determine the price of development capital. This further exacerbates the perception of high risk and risk aversion of both developers and funders related to urban regeneration, which leads to non-delivery of needed urban regeneration actions.

2.1.5.2. Externalities

(30) Externalities arise where market players do not internalise the whole benefit or cost of their actions, because of incomplete property rights or obligations related to those actions. Positive externalities lead to a market failure if they cannot be included in the

[9] "Identification of Potential UDFs Project Portfolio for JESSICA and Promotional Events", Deloitte MCS Limited, 2011, p.9.

pricing mechanism while the relevant costs still need to be covered. The general rationale along the positive externality factor in the context of urban regeneration is that an investment project may achieve much broader and far-reaching spill-over effects on the economy, and the society in general, than those measured by the very financial return from the investment. Many positive externalities are not captured by the market, while their costs are internalised by the urban projects, which leads to a reduced commercial viability. Negative externalities cause a market failure where a market player does not fully internalise the cost of its action which are ultimately born by another party or the society as a whole. In the context of urban regeneration, negative externalities are often related to extra costs of urban investments which do not result in corresponding returns.

(31) In the context of urban development actions in Bulgaria, according to the Bulgarian authorities, the following externalities are evidenced:

(a) Urban development projects often include as their integral part elements comprising public realm (e.g. public spaces, residential parking, kindergarten other elements of adjacent technical infrastructure for public use, etc.). Those elements produce no, or insufficient, revenue to project investors, while they are necessary for the overall success of the project and their cost is included in the project investment. The lack of functional correlation between project's investment and revenues in such cases may significantly reduce the commercial viability of urban projects.

(b) In many cases positive externalities of urban regeneration projects are not reflected in the market price of developed property. This is the case when the project takes place in a previously developed area and its completion brings positive benefits to surrounding area and neighbourhoods, such as improved local build environment and adjacent infrastructure, better landscape view, positive environmental and health effects, etc. (which could, however, in the long run, be reflected in an increase in value for the area’s properties). This wider positive effect, however, does not translate directly and immediately into property returns and the private market therefore fails to price it in the value of the developed property.

(c) Urban development in large cities in Bulgaria could involve brownfield regeneration, which in many cases is related to decontamination and/or demolition of obsolete plants and infrastructure. This results in extra costs, which leads the overall redevelopment cost to be high in comparison with the price that can be realised on the market. In some cases this could even eliminate completely the commercial viability of regeneration (costs exceeding the potential returns and market value). In such instance the market players would choose not to deliver the regeneration in question, while from a wider perspective such regeneration would be beneficial to the society.

2.1.5.3. Coordination problems

(32) Coordination problems lead to market failures, where there is uncertainty about the collaborative outcome of market players which prevents the effective design or even the conclusion of cooperation agreements, leading to non-delivery or inefficiency of actions requiring strong collaborative effort of a variety of development parties. The failure of stakeholders to coordinate in order to reap the benefits of a better situation may prevent efficient market outcomes and thus jeopardize overall economic development.

(33) In the context of urban regeneration, coordination problems could be caused by failures in the regulatory framework, the lack of a common approach to the need for, the design and/or the implementation of actions, or network failures. Overlaps are possible with imperfect or asymmetric information that may also prevent urban stakeholders from taking mutually beneficial decisions.

(34) In the context of urban regeneration in Bulgaria, the Bulgarian authorities informed the Commission about the following coordination problems acting as impediments to the effective design and efficient delivery of urban development projects:

(a) For a number of reasons, among which the very recent transformation of the Bulgarian economy into a free market economy and the prevailing 'grant mentality' of local development stakeholders towards financing of urban development, the urban property regeneration market is just emerging and is still in an embryonic phase. While there are experienced developers already active in the Bulgarian property market who may deliver urban regeneration projects, and there are also funders with a track record in providing finance to property development, including inter alia to urban development projects, those two counterparties still very rarely, and on an exceptional basis, interact in the area of urban regeneration. This has a number of negative impacts. In the first place, this basically hampers the efficient interaction of the demand and supply sides of urban regeneration, as the lack of a 'marketplace' prevents demand and supply being properly formulated and manifested, so that they could interact and produce an efficient market outcome. Second, the lack of a functioning market results in an unavailability of reliable information on the fair market value of urban regeneration property, and also in a lack of an authentic mechanism to determine the fair price of development capital. This further exacerbates the perception of high risk and risk aversion of both developers and funders, which leads to non-delivery of needed urban regeneration actions.

(b) The lack of practical experience of local authorities in successfully managing Public-Private Partnerships (PPP) implementation is another impediment to efficient delivery of urban regeneration actions. A 'negative experience with PPP implementation' has led to a general discouragement and reluctance[10] of authorities (both at national and local level) to apply PPP as a mechanism for the delivery of public services and development of public property, including inter alia, urban regeneration actions.

(c) There are still insufficient levels of integration of the spatial and the socio-economic dimensions of the urban development planning process. Bulgarian legislation distinguishes between two parallel and supposedly coordinated planning processes, which are regulated by separate laws: Spatial Planning (regulated by Territorial Planning Act) and Regional Development Policy (regulated by Regional Development Act). Spatial planning is carried out at national and regional/district levels through Spatial Schemes and at local level through Spatial Plans (Master Plans and Detailed Plans). The regional development policy is implemented through a system of coordinated strategies and plans for the different territorial

[10] JESSICA Preliminary Study for Bulgaria, p.62 states that local administrations have little experience with the PPP schemes: "The common opinion of the municipal representatives is that to implement PPP models out of the scope of the Public Procurement Act and the Concessions Act is too heavy and risky. In general, all municipalities prefer to use the EU grant schemes, and to avoid potential loan obligations."

levels, the Municipal Development Plans notably serving as its main pillar.[11] As a result, urban development plans, clearly integrating in a single document the spatial and socio-economic development aspects, do not exist, which makes it necessary to ensure compliance of potential JESSICA urban regeneration projects in parallel with both planning documents. While integrated urban development plans will be enacted for the next programming period (2014-2020)[12], the JESSICA implementation now would provide valuable experience and 'best practice' guidance to support the process of elaboration of those integrated development plans.

(d) Lack of an 'investment approach' among urban authorities and other urban development stakeholders. They rather view themselves as potential grant-beneficiaries who need to receive aid funding by the State to provide public goods and services, rather than an investor who should pursue the delivery of those in an economically viable and sustainable way. This leads to differing attitudes to, and diverging interest in, urban development among the major urban development parties - the urban authorities and the potential investors. While the former view urban regeneration as a 'gift' to the local community rather than an investment which pays itself off, the latter seek markets returns for their funding and therefore prefer profit-generating, sustainable urban projects. This clearly results in non-delivery of economically viable projects with a potential for significant positive impact on the local communities, i.e. an underinvestment in urban development.

(e) Urban authorities view themselves as the main generators of projects that are to meet the needs of the local community and do not easily accept an eventual leading role or more active participation from the private sector, both in terms of financial resources and managerial experience[13]. This is however combined with a poor management and knowledge capacity to initiate and implement complex long-term projects, which is further aggravated by the short-term thinking of local authorities usually limited to their 4-year political mandate. This leads to (i) coordination problems vis-a-vis the other urban development stakeholders, notably potential private investors, but also to (ii) asymmetric information available to various stakeholders. These market failures lead to high information and transaction and agency costs, and higher risks, which are inevitably priced into the cost of investment; in other cases they result in non-initiation and/or non-delivery of urban regeneration projects that could bring high socio-economic impact.

2.1.5.4. Risk aversion

(35) Risk aversion exists in situations where developers and investors attribute risks higher than market levels related to investments in particular locations/sites or for specific uses. Urban regeneration in Bulgaria experiences both aspects of risk aversion, because of its inherent characteristics. It usually happens in declining areas of derelict urban environment and/or in urban poverty pockets of high unemployment, low income and

11 For further details on the regional development planning context see JESSICA Preliminary Study for Bulgaria, Deloitte Bulgaria, 2009, p.26-36.

12 Grants in the total amount of approximately EUR 21 million were awarded in June to the 36 large and medium-sized cities under the OPRD funding scheme BG161PO001/1.4-07/2010, to finance the preparation of 'integrated plans for urban regeneration and development'. Plans are expected to be drafted by mid-2013, after which they will be released for public consultation and adoption by relevant authorities, to serve as a planning framework for the sustainable urban development until 2020.

13 "Identification of Potential UDFs Project Portfolio for JESSICA and Promotional Events", Deloitte, 2011, p.9.

social exclusion. These investments incur extra costs while revenue projections remain uncertain because of presumed low demand.

(36) The main elements of risk in the appraisal of urban regeneration projects comprise planning, development costs, decontamination, project duration, yield and rent, finance and volatility. Regeneration plans usually involve significant upfront preparatory costs which increase significantly the term between first investment and first returns. This results in overly conservative projections of the cost and value of new developments in such locations or for such specific uses, and affects both the level and pricing offered by debt providers and the return developers and equity investors would require.

(37) Market failures at the project level as identified above are evidenced at the financing market level also. Since 2008 financial activity both at national and at regional/local level has significantly decreased, which seems to stay unchanged at least in the perspective of the next few years. Credit institutions are being more selective in discriminating risk as a result of the dramatic increase in defaults (it has tripled in the last two years[14] reaching BGN 3.6 billion or 5.7% of the credit portfolio of all banks. Due to the burst of the real estate bubble, as evidenced by the steep drop of property prices[15], defaults in the real estate sector increased, which pushed the commercial banks to adopt a rather conservative approach to property development projects in general. As a result, obtaining bank loans with the long maturities needed for urban projects has become very difficult. The perception of higher risks also affects the level and pricing of debt. As a result, the regeneration projects are less able to attract bank loans and when loans can be contracted, they are more expensive, thereby increasing financing costs and further exacerbating the financial viability of projects.

(38) The perception of risks also affects the level of return that developers and investors require and the levels of risk that they are willing to accept. Insufficient debt funding often leads to project investors requiring higher levels of equity from developers before they will provide finance. Given the underdevelopment of the financial market in Bulgaria, the provision of equity is rather scarce. Since 2008 equity providers are reluctant to involve themselves in property development, either commercial or residential. This renders it difficult to build up a proper project finance structure of urban regeneration actions, which increases financing costs and impacts on the actions' overall financial viability.

(39) Alternative funding sources, such as invoice and commercial paper discounting, are practically not used because of the underdeveloped status of the Bulgarian financial market.

2.1.6. Equity objective: Addressing socio–economic problems in deprived urban areas

(40) In addition to addressing the above economic inefficiencies in the form of market failures, investments into UDPs may, as pointed out by the Bulgarian authorities, seek to compensate for economic or social problems that characterise deprived urban areas. Those problems also affect the viability of investments, in particular in regions qualifying as assisted areas within the meaning of the Guidelines on National Regional Aid for 2007-2013[16]. This is the case

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[14] BNB Report on Credit Quality, June 2011, http://bnb.bg/BankSupervision/BSCreditInstitution/BSCIFinansReports/BSCIFRBankingSystem/BS_201106_EN

[15] National Statistical Institute, Sept 2011, http://www.nsi.bg/ORPDOCS/HFund_3.1-EN.xls

[16] OJ C 54, 4.3.2006, p. 13.

of the whole territory of Bulgaria, which is eligible for national regional aid for the period 2007-2013 under the derogation of Article 107(3)(a) of the TFEU.

(41) The relevance of the equity objective for Bulgaria arises from the Bulgarian Operational Programme "Regional Development"[17]. It recognises the cohesion objective, stipulating that the OPRD is prepared in line with the Lisbon agenda and the sustainability principles defined in the Gothenburg strategy for sustainable development. The OPRD underlines that it targets "investing in the drivers of growth and employment, supporting the implementation of coherent strategies, improving governance and introducing integrated approaches in order to promote balanced development, sustainable communities and social inclusion".

(42) The OPRD formulates and promotes 3 cohesion objectives as follows:

(a) Sustaining cities as motors of regional development;

(b) Reaching internal cohesion inside the urban areas or overcoming internal urban disparities; and

(c) Reaching balanced development by improving links between the economically strongest cities and under developed urban areas. JESSICA may be considered as an intervention tool for the first and second cohesion dimension, e.g. sustaining the cities as drivers of development and internal urban cohesion.

2.1.6.1. Sustaining the cities as drivers of economic development

(43) The need to sustain the cities as drivers of economic development is justified in the OPRD 2007-2013, and has become even more crucial during the crisis. The crisis damaged most severely the small businesses, the small municipalities and the rural areas. In such a situation it is crucial to preserve the cities and the comparatively big viable companies in the urban centres. They are the ones that ensure income to the State budget and provide job and business opportunities for the population and the small and medium-sized entities (SMEs) inside the cities and in the area around them.

(44) The need to support viable urban centres, considered as drivers of development, can be illustrated on the basis of data on the negative movement of population during 2010 inside the districts, calculated as a percentage of the total population of the city. With few exceptions the data shows that the negative movement of people is smallest for the district centres, compared to the small towns in the same district. For example in Ruse the negative movement of people is -128 people, which accounts to – 0.07% of its 174,378 population compared with -146 people for the small municipality of Dve Mogili in the Ruse district, accounting to -1.45% of its 10,089 citizens. Similarly in the district of Stara Zagora the most severe negative movement of people is in the medium-size municipality of Kazanluk, accounting to -0.6% (-455 people), compared to -0.38% (-617 people) in the municipality of the Stara Zagora. Generally the data shows a correlation between the size of the municipality and the negative movement of people, particularly for the big centres. There are however exceptions for the Black Sea coast and some other specific regions.

[17] Operational Programme "Regional Development", Bulgaria, 2007-2013, p.8.

(45) However, the overall population data shows that during the last 10 years the population of Bulgaria has been annually decreasing[18] by 0.7%. In total, the nation has shrunk by 564,331 citizens since 2001. Though the country has become more urbanised during the last 10 years, only two districts have increased their population (Sofia and Varna) while the others have shrunk. On the other hand 39.2% of the population nowadays lives in only 9 municipalities with populations above 100,000.

(46) In general, the demographic data shows that the negative demographic trend is valid for the whole Bulgarian territory. However the big municipalities and particularly the big cities are the only ones that are able to compensate the strong emigration trend and act as drivers of recovery. In general, the current macro-economic environment in Bulgaria suggests that in a situation of restricted investments it could be a relevant strategy to utilize the scarce investment resources for preserving and encouraging the engines of development or rather the drivers of recovery, the urban city centres. The preliminary JESSICA study takes this into account, pointing out "the specific role of urban areas for promotion of cities as motors of regional development"[19]. Such an approach, addressing the need to identify engines of development is also reflected in the latest evaluation of the OPRD[20], suggesting that in the planning of the next programming period it is necessary to identify the regions that will act as engines of development.

2.1.6.2. Internal cohesion - overcoming the internal gaps in urban development

(47) The second cohesion dimension that is relevant for JESSICA is overcoming the internal development gaps and deprivations inside the urban areas. The commitment of Bulgaria to the EU objectives of social inclusion dates back to 2005 when the country signed a Social Inclusion Memorandum with the European Commission, following a relevant clause of the Accession Agreement. The Social Inclusion Memorandum[21], and the related action plans put forward a number of priorities, objectives and measureable indicators. Among them there are several issues that can be addressed through UDPs under JESSICA. These are:

(a) Infrastructure for accessible social services;

(b) Access to transport, including transport for integrated education;

(c) Accessible and quality health care;

(d) Housing policy;

(e) Educational infrastructure;

(f) Infrastructure for people with disabilities and children with special needs; and

(g) Vulnerable ethnic minorities and particularly Roma.

(48) According to the Preliminary JESSICA study, Bulgarian cities suffer from a number of chronic problems - neglected city centres with outdated infrastructure, residential areas with housing in poor condition, lack of green areas and public spaces, decaying brownfield zones,

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18 National census, 2011, NSI, http://www.nsi.bg/EPDOCS/Census2011final.pdf

19 JESSICA Preliminary Study for Bulgaria, Deloitte, 2009, p. 15.

20 Mid-term Evaluation of Operational Programme "Regional Development" 2007 – 2013, KPMG, 2011, http://www.bgregio.eu/media/files/Programirane%20i%20ocenca/04_mid-term%20evaluation.En.pdf.

21 Joint Inclusion Memorandum, http://www.socialinclusion-bg.net/documents/sibg/bg/Jim_Bulgaria.pdf

urban sprawl in suburban areas lacking adequate infrastructure, underdeveloped transport network, low quality public transport, traffic congestion, pollution, social segregation, etc.[22].

2.2. Budget, granting authority, duration and legal basis

2.2.1. Budget

(49) According to the Bulgarian authorities, the public budget for the measure will be EUR 66 million. This budget includes (i) the initial amount of EUR 33 million provided to the JHFB for a first cycle of investments to be made until 31 December 2015, and (ii) the subsequent re-investments of the returns generated by the initial investments until 31 December 2025. The budget will be used for investments containing State aid within the meaning of Article 107(1) TFEU aid, as well as investments on *pari-passu* conditions together with private co-investors that are free of aid.

(50) The aid is funded under the Bulgarian Operational Programme "Regional Development" 2007-2013 from ERDF resources and match-funding from the resources of the Bulgarian Government.

(51) In line with Article 4(2) of Regulation (EC) No 794/2004[23], budget increases of more than 20% will be subject to notification to the Commission.

(52) The value of public in kind contributions such as provision of public land granted will be established under market conditions. The Bulgarian authorities committed to respect applicable Union rules such as the Commission Communication on State aid elements in sale of land and buildings.[24]

2.2.2. Granting Authority

(53) The Bulgarian Ministry of Regional Developments and Public Works will serve as the granting authority.

2.2.3. Duration

(54) Without prejudice to specific provisions under the Structural Funds rules, as far as compliance with State aid rules is concerned the duration of the measure is until 31 December 2025. The duration corresponds to the expected 10-year lifespan of the UDF investments: the initial UDF investments of EUR 33 million in UDPs until the end of 2015, as required by the SF Regulations and the subsequent re-investments in UDPs from the returns generated by the initial investments until the end of 2025.

2.2.4. Legal basis

(55) The implementation of the JESSICA initiative in Bulgaria is regulated by the Funding Agreement signed on 29 July 2010 between the Government of the Republic of Bulgaria and the European Investment Bank. The Funding Agreement's provisions are complemented by those of the two Operational Agreements concluded between the Holding Fund and the UDFs (see recital (3)). Those three documents, which form part of the notification, define the tasks and requirements for the Holding Fund as well as for

[22] JESSICA Preliminary Study for Bulgaria, Deloitte, 2009, p. 92.
[23] OJ L 140, 30.4.2004, p. 1.
[24] OJ C 209, 10.07.1997, p. 3.

the UDFs, and stipulate, amongst other matters, investment strategy and planning, selection of UDPs, monitoring and reporting, remuneration and compliance with State aid rules.

(56) The Bulgarian authorities committed to alter and/or amend the Operational Agreements as well as any other relevant document in order to bring the notification in line with this decision and send copies of the up-dated documents to the Commission.

(57) Additional legal sources relevant for the notified measure are the Structural Funds provisions mentioned above in footnote 3.

2.3. Form of aid: Granting of revolving investment at sub-commercial conditions to UDPs

(58) As foreseen in Article 43(1) of the Implementing Regulation and the relevant funding agreements, investments in UDPs will be made in a revolving way, namely, in the form of loans, equity and guarantees. Such repayable investments will be "recycled" and become available for further reinvestment in UDPs.

(59) To remedy the above-identified market failures and to facilitate socio-economic development in deprived urban areas in the Bulgaria, the measure will act as a catalyst to leverage private funding to finance UDPs. According to the Bulgarian authorities, the measure will provide aid in the form of sub-commercial public (subordinated and/or at a preferential interest rate) loans, equity investments together with private co-investors benefitting from preferential *non-pari-passu* terms as compared to public investors, as well as guarantees on repayable investments provided on the account of public funds which do not comply with the conditions ruling out the existence of aid. Deviation from market rules will be limited to the necessary minimum (as to its limitations, including the concept and establishment of a Fair Rate of Return (FRR) please see section 2.7.5.4 and 2.7.6 below).

(60) Detailed investment terms and conditions, including the choice of investment tools – sub-commercial loan, equity and/or guarantees - will be determined prior to making an investment on the basis of business plans prepared for each UDP and will depend on the exact nature and financing characteristics of the project and the lack of commercial viability, which will be evaluated on a project-by-project basis (for details, please see section 2.7.5 below).

2.3.1. Sub-commercial equity instruments

(61) Under the measure, private investors could receive preferential *non pari-passu* (and therefore sub-commercial) investment conditions as compared to public investors. In accordance to Article 43(5) of the Implementing Regulation, returns from investments, less a pro rata share of the management costs and performance incentives, may be allocated preferentially to private investors as described below.

(62) Various forms of preferential equity instruments can be granted by the UDF, depending on project nature and its financing needs, which can comprise for example, subject to the profit-loss sharing arrangements specified below:

(a) Preferential return - public equity contribution requiring a lower rate of return than private equity. This instrument will result in different expected IRR rates for the private equity investor compared to the IRR on the equity investment provided under the measure;

(b) *Priority return* – public equity contribution allowing for a rate of return being paid to the private equity investor first. It means that after the equity initially invested is repaid to both public and private investors, the private equity investors takes the remaining capital return to enable a profitability that is equal to the FRR previously agreed. The public equity investor then takes any remaining capital return to enable the same level of profitability as the private investor. Above the rate, any surplus returns are then split proportionately and at the same time between the private investor and the investment provided under the measure;

(c) *First losses* - UDF equity investments could rank behind private equity for repayment, therefore effectively being exposed to first loss in the event of poor investment performance, i.e. a (partial) loss being made on the capital invested. The UDFs will invest in a project which at the time of the investment, following the application of the measure, is not estimated to make a loss on the capital invested, but in instances where an actual loss is made, the UDFs would adopt a capped 'first loss' position of 25 % of the overall outstanding loss, in any case limited to the level of the UDF's investment in the project. By applying the first loss tool, the UDF would reduce the risk profile on the development and subsequently the viability gap. The reduced risk profile will be taken into account when establishing the FRR.

To protect the public investments, a preferential return structure is preferred to a first loss position and the first loss position will only be used where it is absolutely necessary. The tool can therefore only be utilised where it reduces the viability gap of a project such that it breaks even and it should only be used where the above options have been exhausted and have proved insufficient to address the viability issues of the project.

According to the Bulgarian authorities, the UDF managers will have limited economic incentives to use this mechanism, as they will incur a financial loss if they use it; fundamentally it will also reduce the capital they have available for reinvestment, which will erode their fee earning capacity.

2.3.2. Sub-commercial loans

(63) In addition to preferential equity instruments, aid can also be granted in the form of sub-commercial loans, i.e. loans with an interest rate below market rate or other preferential conditions such as different maturity. Provision of sub-commercial loan will result in a higher IRR for the private project investor and follow the same limitations as sub-commercial equity investments under the measure, i.e. private project investors will be ensured an IRR corresponding but not exceeding the relevant FRR on their investments.

2.3.3. Sub-commercial guarantees

(64) Under the measure aid can also be provided through guarantees on repayable investment in UDPs provided on the account of the public funds at sub-commercial terms. This is the case when guarantees issued by UDFs do not comply with the conditions ruling out the existence of aid provided for in Section 3 of the Commission Notice on the application of Articles 87 and 88 of the EC Treaty to State aid in the form

of guarantees[25], including inter alia, a price being paid for the guarantee below the minimum annual premium ("safe-harbour premium"), established under point 3.3 of that Commission Notice. Provision of sub-commercial guarantees will result in a higher IRR for the private project investor and follow the same limitations as sub-commercial equity investments under the measure, i.e. private project investors will be ensured an IRR corresponding but not exceeding the relevant FRR on their investments.

(65) Sub commercial guarantees cannot exceed of 30% of the repayable investment, in any case limited to the level of the UDF's investment in the project.

2.4. Funding architecture I: Overview

(66) As foreseen under Article 43 of the Implementing Regulation, investments into eligible UDPs will be made via investment vehicles, i.e. UDFs. UDFs will be managed by professional independent fund managers, selected through an open and transparent procedure that will make investment decisions within the agreed investment strategy. The managers will carry out the due diligence and financial appraisal in the project structuring phase, price the loan and negotiate equity profit-sharing arrangements with other equity holders, and monitor project performance until the exit.

(67) Investment becomes more reliable because UDF managers provide professional project appraisal. They thereby ensure that UDPs are feasible from the economic, social and technical points of view and comply with the eligibility criteria in the relevant regulations. They also analyse the risks involved, the information on financial structure and the expected revenues for the different stakeholders.

(68) As foreseen in the Funding Agreement as well as in the Operational Agreements, public funding to the UDFs will be channelled through the JHFB that is an investment vehicle set up to invest the public funding under the measure in several UDFs.

(69) The participation of both JHFB and additional UDFs allows the public authorities to rely on the financial expertise present in these institutions. It also allows them to leverage additional funding, as public resources and other public/private funding are pulled together at the UDP level. Moreover, the intention is to build a portfolio of transactions diversified in terms of size and sector so as to mitigate investment risks through the "portfolio effect".

(70) The funding objectives, terms and conditions provided to JHFB and subsequently UDFs are contractually specified in the Funding Agreement, in particular in its Chapter 7 and Appendix A "*Investment Strategy for Bulgaria*" as well as the Operational Agreements, in particular in their Schedule A *"Investment Policy and Business Plan"* and Schedule B *"Terms Of Project Funding Agreements"*. They will include the investment policy, the rights and obligations of fund managers, investment process, governance rules, monitoring and reporting provisions as well as rules on management fees.

(71) While a large portion of the decision-making process on investments is thus outsourced to the JHFB as well as to UDFs, ultimate responsibility for State aid compliance remains with the Bulgarian authorities.

[25] OJ, C 155, 20.6.2008/C 155 p. 10.

2.5. Funding Architecture II: The Holding Fund

(72) As an option foreseen in the SF Regulations, the JHFB was set up by agreement signed on 29 July 2010, between the Government of the Republic of Bulgaria, and the European Investment Bank. It was established to invest the public resources under the measure in several UDFs. In accordance with the SF Regulations, the JHFB has been established as a separate block of finance within the fund manager European Investment Bank (EIB). Separate accounts will be kept.

(73) The HF structure provides a mechanism for the diversification of investments in several types of UDFs and more effective controls. It is intended to achieve significant economies of scale and act as centralised manager for payments and a catalyst in the investment process.

2.5.1. Holding Fund's funding agreement

(74) The Funding Agreement sets out the funding terms and conditions, in line with paragraphs 1 and 2 of Article 44 of the Implementation Regulation, such as the investment strategy and policy (including an indication of the target UDPs and products), appraisal and selection of UDFs, monitoring, reporting and auditing systems, and winding-up provisions (including the reutilisation of resources).

2.5.2. The Holding Fund's investment strategy

(75) In line with paragraph 1 of Article 44 of the Implementing Regulation, the Funding Agreement makes, in particular under its Chapter 7, "*Investment Strategy"* reference to urban development studies and IPSUDs included in the relevant ERDF Operational programme "Regional Development" 2007-2013 Bulgaria. According to the Bulgarian authorities, the JHFB's investment strategy reflects furthermore policy goals agreed with the Bulgarian authorities that are in line with the SF Regulations and based on the investment priorities defined in the IPSUD and the objectives set out in the OPRD for Bulgaria. In addition, it reflects the key findings of the analysis on efficiency as well as on equity objectives described above.

(76) As for urban development studies, the analysis of specific urban development needs and actions in Bulgaria was carried out through a so-called JESSICA Preliminary Study for Bulgaria[26]. It represents a key step which permitted the institutions involved to define urban development needs and an investment strategy in accordance with the sustainable urban development objectives. The evaluation study comprises inter alia an analysis of the context for JESSICA in Bulgaria and provides recommendations and proposals for appropriate actions regarding possible JESSICA implementation.

(77) According to the Bulgarian authorities, a wide range of UDPs, mirroring the efficiency and equity objectives referred to in section 2.1.5 and 2.1.6, could receive UDF investments. Examples are UDPs aiming at:

(a) Improvement of social integration,

(b) Improvement of mobility,

[26] http://www.eib.org/attachments/documents/jessica-preliminary-study-for-bulgaria-en.pdf

(c) Improvements in energy management and energy efficiency and waste management, if being a part of a larger integrated project,

(d) Increase of the use of renewable energy, if being a part of a larger integrated project,

(e) Re-use of industrial and degraded areas,

(f) Development of high technology and added value infrastructure,

(g) Housing within the limits laid down by SF Regulations, if being a part of a larger integrated project,

(h) Social, educational, cultural and health infrastructure,

(i) Improvement of urban physical environment,

(j) Urban transport.

2.5.3. Management of the Holding Fund

2.5.3.1. Responsibilities of the HF manager

(78) The Bulgarian authorities have set up the JHFB and entrusted the EIB with management of the JHFB comprising the following activities:

(a) Selection of and investment in UDFs: launching a tender process, evaluation of the business plans submitted by UDFs and the quality of the management, negotiation and signing of Operational Agreements with UDFs;

(b) Operation phase: evaluation of the updated business plans submitted by UDFs in the selection and operational phase, monitoring and control of UDF investment activities in accordance with the Operational Agreements, reporting;

(c) Treasury management of the outstanding funds.

2.5.3.2. Selection process

(79) Based on Article 44 of the General Regulation, the Bulgarian authorities decided to entrust the EIB with the management of the JHFB through a direct award of a contract.[27] The General regulation allows the EIB to be appointed without procurement procedures.

2.5.3.3. Management fee

(80) Total management fees for the EIB may not exceed, on a yearly average, a cap of […][*]%[28] of the total amounts contributed into the measure.

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27 Funding Agreement signed on 29 July 2010 between the Bulgarian Government and the European Investment Bank.

* Business secret

28 Article 43(4a) of the Implementing Regulation foresees that the management costs for the holding fund may not exceed 2 per cent of the capital contribution to the HF.

2.5.4. Holding Fund investment into UDFs

2.5.4.1. Selection of UDFs

(81) In line with Article 44(2b) of the Implementing Regulation, the EIB launched on 31 March 2011 on its website[29] a call for expression of interest to identify potential UDFs. That call for expression of interest was also published in the Official Journal of the European Union[30]. The EIB received in total five offers from three applicants covering both Lot 1 (Sofia) and Lot 2 (six biggest cities). The offers were examined on the basis of the exclusion and selection criteria. Among the candidates who met the exclusion and selection criteria, two offers, including the corresponding business plans, were evaluated in line with the award criteria.

(82) In line with Article 43(2) of the Implementing Regulation, UDFs are to be selected on the basis of the business plan established by the UDFs specifying, in particular, the following elements: the target market and projects, investment conditions, budget, ownership and financing, provisions on professionalism and independence of the management, winding-up provisions.

(83) To assess the business plan and the suitability of potential UDFs, the JHFB applied assessment criteria such as the quality of the applicant's investment strategy and the governance structure including experience in the market, the level of the annual management fee charged and the ability to provide own investment resources or attract third party private co-financing.

(84) Since the JHFB delegates decisions to invest in individual UDPs to the UDFs, the JHFB relies on appraisal, risk-control and monitoring standards of the UDFs. Therefore, in order to ensure that the JHFB is financially sustainable and that the public investments are repaid and recycled, the JHFB has carried out a credit/investment risk assessment of the selected UDFs as well and determined ex-ante the exit policy from those UDFs.

2.5.4.2. JHFB Investment Board

(85) The JHFB is governed by an Investment Board, the body that supervises and is broadly responsible for governing the implementation of the JHFB. Implementation of the JHFB includes approving or rejecting recommendations made to the Investment Board by the EIB as the JHFB manager. The Investment Board of the JHFB will carry out the following tasks:

(a) After being notified of the selected UDF(s) by the JHFB, the Investment Board is responsible for ratifying (or rejecting) the proposal;

(b) The Investment Board will perform periodic reviews of the JHFB’s overall performance in implementing the investment strategy and the underlying projects;

(c) In consultation with the Bulgarian authorities, the Investment Board will review the progress and the strategy of the JHFB;

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29 http://www.eib.org/attachments/eoi/vp960_tor_en.pdf

30 http://ted.europa.eu/udl?uri=TED:NOTICE:101186-2011:TEXT:EN:HTML&tabId=1

(d) The Investment Board will supervise the activities carried out within the scope of the Funding Agreement, including UDF selection, UDF contract management, budget, costs and reporting.

(86) The Investment Board consists of five Members and five alternates appointed by the Minister of Regional Development and Public Works. The members of the Investment Board are contractually obliged to act in the sole interest of the JHFB. The EIB shall be entitled to designate up to two of its officials to participate in the Investment Board sessions as observers.

2.5.5. Monitoring implementation at UDF level

(87) In accordance with Article 43(2) of the Implementing Regulation, the JHFB will monitor the implementation of the business plan and the performance of each selected UDF in accordance with the terms and conditions of the applicable Operational Agreement through the receipt of quarterly and annual progress reports, audited annual financial reports, and a yearly internal valuation report produced in accordance with IFRS setting out the value of the portfolio of UDPs.

2.6. Funding architecture III: The UDF(s)

(88) The two UDFs are investment vehicles which have been set up for the purpose of providing financing for the urban projects included in IPSUDs.

(89) As is the case with the HF structure, the UDF structure provides a mechanism for the diversification of investments in several types of UDPs and more effective controls. It allows significant economies of scale to be achieved and acts as centralised manager for payments and a catalyst in the investment process.

2.6.1. Operational agreements

(90) In line with Article 43(5) of the Implementing Regulation, the Operational Agreement between the JHFB and the parties of UDF 2 was signed on 27 and 28 December 2011 and the Operational Agreement between the JHFB and the parties of UDF 1 was signed on 30 May 2012.

(91) The Operational Agreements set out the funding terms and conditions, such as the investment strategy and policy of the UDF, monitoring, reporting and auditing systems, as well as winding-up provisions, including the reutilisation of resources.

2.6.2. Legal form and structure of the UDFs

(92) The UDFs have been established as separate legal entities, set up as joint stock companies. The shareholder of UDF 1 is the Fund for Local Authorities and Governments EAD ("FLAG") and the shareholders of UDF 2 are Société Générale Expressbank AD, Elana Holding AD, Elana Investment AD and Balkan Advisors AD.

2.6.3. *UDF management*

2.6.3.1. Responsibilities

(93) The JHFB delegates to the UDFs individual investment decisions that will be made using commercial appraisal principles within the limits of the investments strategy agreed and the policy objectives sought. The key tasks envisaged for the UDFs, i.e. its management, are to:

(a) Identify, appraise and structure investments in viable UDPs which fit within the agreed business plan of the UDF and the investment strategy of JHFB;

(b) Monitor UDPs' operational and financial performance and manage appropriate exit strategies from UDPs to ensure most profitable investment exits;

(c) Seek to secure maximum co-financing at UDP level to ensure that UDF's investment is sufficiently and appropriately leveraged;

(d) Monitoring and reporting to the JHFB on the UDP portfolio performance, providing the necessary information to ensure compliance with the relevant EU rules;

(e) Appropriately promote investments in UDPs.

2.6.3.2. Remuneration

(94) The JHFB will compensate the UDFs for investment management services in the form of a management fee agreed in advance and contractually defined in the Operational Agreements with UDF 1 and UDF 2. The precise management fee structure and its level have been determined through the competitive process of selecting UDFs and was an important part of the selection criteria.

(95) The Bulgarian authorities emphasise that the remuneration mechanism for UDF managers provides incentives ensuring a balanced approach between policy objectives and profit maximisation thereby minimizing the aid granted.

(96) For the period starting from 1 January 2016, the management fees paid to the UDF managers will be linked to the performance of the investment i.e. the remuneration fee will be linked to returns generated by the investment. The presence of a success based remuneration element ensures the alignment of interest between the Managing authorities and the UDF managers responsible for the investment process and thus guarantees that the latter will take economically sound decisions and invest in performing investments.

(a) <u>Remuneration provisions concerning the UDF 1</u>

(97) From the Operational Agreement's signature date until 31 December 2015, the UDF will be entitled to receive an annual management fee equivalent to […]% per annum of the amount managed under the measure.

(98) As regards the period from 1 January 2016 until the winding up of the UDF, the Bulgarian authorities have provided specific clarifications on the structure of the remuneration of the manager of UDF 1 and confirmed that the latter shall be entitled to receive a management fee of […]% per annum of the outstanding principal under the

project funding agreements with Final Recipients as well as on interest and/or any other profits paid back to the UDF by the Final Recipients to the Reserve Account[31] during the reference period under which the management fee is due. The payments of the management fee are also limited to the amounts available in the Reserve account.

(99) The management fee, for the period starting from 1 January 2016, is earned on amounts due not yet repaid by final recipients. The Operational Agreement also includes provisions enforcing the necessity to repay fees already received by the UDF Manager on Amounts Due and which could not be re-paid in the agreed time-frame, thus reinforcing the credibility of the abovementioned condition. In addition, if the value of Amounts Due that are written off is to exceed […] per cent of the total amounts disbursed to Final recipients (Recovery floor), the UDF manager will have the obligation to repay […]% of all written off amounts due in excess to this […]% Recovery floor.

(100) Without prejudice to Article 43 of Commission Regulation (EC) No 1828/2006, as of 1 January 2016, the management fee shall under no circumstances exceed, on an annual average, 3% of the amount disbursed to Urban Development Projects.

(101) The management fee shall not be calculated on the interest earned by the UDF on any deposits.

(b) Remuneration provisions concerning the UDF 2

(102) From the Operational Agreement's signature date until 31 December 2013, the UDF will be entitled to receive an annual management fee equivalent to […]% per annum of the amount managed under the measure.

(103) For the financial years 2014 and 2015, the UDF will be entitled to receive a management fee corresponding to […]% per annum calculated on the amounts disbursed to final recipients in Urban Development Projects.

(104) For the period from 1 January 2016 until the winding up of the UDF, the UDF shall be entitled to receive a management fee of […]% of the total amount of repayments and profits made by final recipients. According to the Bulgarian authorities, this provision will incentivise the UDF manager, to structure projects in the most profitable way possible. The payments of the management fee are also limited to the amounts available in the Reserve account.

(105) The management fee, for the period starting from 1 January 2016, is not earned on amounts due but not repaid by final recipients. The Operational Agreement also includes provisions enforcing the repayment of fees already received by the UDF Manager on Amounts Due not paid, thus reinforcing the credibility of the abovementioned condition. In addition, if the value of Amounts Due that are written off is to exceed […]% of the total amounts disbursed to Final recipients (Recovery floor), the UDF manager will have the obligation to repay […]% of all written off amounts due in excess to this […]% Recovery floor.

[31] The Reserve Account is a blocked account in the name of the UDF, pledged in favour of the EIB, to which any payments made by the Final recipients under project funding agreement are collected, and repayments due to the EIB are made.

(106) Without prejudice to Article 43 of Commission Regulation (EC) No 1828/2006, as of 1 January 2016, the management fee shall under no circumstances exceed, on an annual average, 3% of the amount disbursed to Urban Development Projects.

(107) The management fee shall not be calculated on the interest earned by the UDF on any deposits.

2.7. Funding architecture IV: Eligibility criteria for UDF investments

2.7.1. Eligible beneficiaries

2.7.1.1. General conditions

(108) Under the notified measure, the Bulgarian authorities intend to grant State aid to private investors[32] in UDPs. Such investors can benefit from preferential investment conditions as compared to public investors.

(109) Beneficiaries of aid under the measure must be located or exercise economic activities in Bulgaria. UDPs supported under the measure must be carried out in the urban areas of Bulgaria defined in the IPSUD as pointed out above.

(110) The physical delivery of a UDP, e.g. construction of buildings, shall be carried out under market conditions and therefore not benefit from any State aid granted under this scheme.

(111) If the preferential investment conditions granted under the measure translate into sub-commercial conditions for operators or end-users of UDPs (e.g. a shop tenant paying a sub-commercial rent in a building that has been built or renovated as part of UDPs), State aid potentially included in those conditions is not part of the current notification.

(112) Each UDF receiving funding from the JHFB under the measure will operate in accordance with a business plan compliant with the UDF investment policy. The quality of the UDF's investment strategy is one of the selection criteria established by the JHFB.

(113) Each UDF's investment policy and business plan will be in line with the investment strategy of the JHFB.

(114) In order to ensure a minimum diversification of the portfolio of UDPs, the operational agreements[33] with UDFs provide that the maximum financial amount to be invested by the UDF in a single UDP will be capped at 50% of the funds provided by the JHFB to the UDF.

(115) UDPs can either be organised as a separate block of finance following international accounting standards and normally within the legal structures of the beneficiary or a UDP can have a legal entity of their own e.g. a Special Purpose Vehicle established in order to run a development project.

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32 Under the measure, the term "private investor" means any investor whether private or public that invests its money in a profit-oriented way in line with market economy logic, in conformity with the Union Courts' rulings on the Market Economy Investor Principle. See for example Case T-163/05 *Bundesverband deutscher Banken* v *Commission* [2010] ECR II-0000, judgment of 3 March 2010.

33 Clause 3.01B(a)(ii)(4) thereof.

2.7.1.2. Contribution to policy objectives

(116) UDPs will comply with the SF Regulations. Each UDP will in addition contribute to the objectives defined in the Operational Programme "Regional Development" 2007-2013 Bulgaria and comply with relevant IPSUDs, including possible quantitative outputs stipulated in the Operational Programme.

2.7.1.3. Repayment of initial investments

(117) Selected UDPs will be economically and technically sound and have a minimum prospect of financial viability. The existence of positive project cash flows is a key financial requirement. It is necessary to at least repay investments in nominal terms. All projects will be assessed in detail by the UDF to determine the robustness of their financing structure.

2.7.1.4. Incentive effect

(118) Investments may in general only be made in non-started UDPs, i.e. if the beneficiary has submitted his proposal for UDF funding before the start of the project work. As pointed out in the Guidelines on National Regional Aid for 2007-2013[34], the notion of 'start of work' will mean either the start of construction work or the first legal commitment in a specific project, excluding preliminary feasibility studies.

(119) When investments are made in UDPs not meeting the requirements mentioned above, then the conditions listed in the last recital of section 2.7.5.3, resulting in the substantial increase of an existing project, must be complied with.

2.7.2. Eligible costs

(120) Investment into urban projects will be made into eligible expenditure determined by the SF Regulations. It will be subject in particular to the following limits:

(121) The Bulgarian authorities will apply the limitation of "investments in material and immaterial assets" relating to "initial investments", i.e. projects involving the setting-up of a new establishment, the extension of an existing establishment, diversification of the output of an establishment into new additional products or a fundamental change in the overall production process of an existing establishment, and the limitation of operating aid, as defined by the Guidelines on National Regional Aid for 2007-2013.

2.7.3. Excluded investments

(122) In line with the SF Regulations, the Bulgarian authorities have committed that the creation and development of additional financial instruments, such as venture capital funds, loan funds or guarantee funds is excluded in line with Article 46(1) of the Implementing Regulation.

(123) No investment will be granted to projects which are active in any of the sectors or is linked to any of the activities specified in Article 1(2) of Regulation (EC) 800/2008[35], i.e. aid to export-related activities towards third countries or Member States, namely aid

[34] OJ C 54/13 of 04 March 2006, paragraph 38, footnote 40.

[35] Commission Regulation (EC) No 800/2008 of 6 August 2008 declaring certain categories of aid compatible with the common market in application of Articles 87 and 88 of the Treaty (General block exemption Regulation), OJ L 214, 9.8.2008, p, 3.

directly linked to the quantities exported, to the establishment and operation of a distribution network or to the other current expenditure linked to export activities as well as aid contingent upon the use of domestic in preference to imported goods.

(124) Enterprises in the shipbuilding, coal, synthetic fibres and steel industry are excluded from the measure, as are enterprises in fisheries and agriculture[36].

(125) No investment will be granted to undertakings which are subject to an outstanding recovery order following a previous Commission Decision declaring an aid illegal and incompatible with the internal market.

(126) No investment will be granted to “a firm in difficulty" within the meaning of Chapter 2 of the Community guidelines on State aid for rescuing and restructuring firms in difficulty.[37]

(127) Furthermore, in line with the SF Regulations, the Bulgarian authorities have declared that the following expenditure is not eligible: interest on debt, decommissioning of nuclear power plants and recoverable value-added tax.

2.7.4. Conditions for private co-investment

2.7.4.1. Minimum size co- investment at risk

(128) As the existence of private co-investors is a significant indicator of the degree of economic soundness of the investment, in case of UDF sub-commercial loans, guarantees or *non-pari-passu* equity, the private investment at risk in any UDP will be significant.

(129) In order to qualify as investment at risk, private investment will either be in the form of equity or any other contribution whose repayment is at least partially subject to the UDP's economic success. For example, standard senior loans or investment amounts benefitting from guarantees or first loss clauses do not qualify as investment at risk.

2.7.4.2. Minimum participation in overall eligible project costs

(130) In addition to the provision of significant investment at risk, private co-investors will provide for at least 50% of the overall eligible project costs.

2.7.4.3. Special conditions for co-investments by the UDF manager

(131) The ability of the UDF managers to provide investment resources from sources other than the JHFB or attract third party private co-financing is one of the selection criteria. In order to meet that criterion, the UDF manager may also invest its own resources.

(132) UDF managers will be contractually prevented from imposing on private co-investors the acceptance of the UDF managers' own resources as a requisite to obtain preferential UDF financing. In other words, private investors may choose to provide co-financing from sources other than the co-financiers selected by the UDF.

[36] The multisectoral framework of the RAG, OJ C 54, 4.3.2006, p. 13.

[37] OJ C 244, 1.10.2004, p. 2.

(133) Whenever investing own resources, the UDF manager will respect arm's length principles and keep transparent records for reporting, monitoring and auditing purposes.

(134) In case a UDF manager intends to invest its own resources on terms different from those applicable to the resources provided by JHFB, the conditions will be assessed by an Independent Expert. The same is true in cases when a UDF manager provides in-kind contribution as a co-investor to a project, where the value of the contribution also has to be assessed by an Independent Expert. For further details on Independent Experts see section 2.7.6.2 below.

2.7.4.4. Special conditions for co-investment at the level of the UDP

(135) Article 78(6) of the General Regulation allows private or public co-financing to be effectively paid in cash or in kind at the level of UDPs without having to be paid at the level of the UDFs. According to the SF Regulations, private or public co-financing paid at the project level would only be eligible if it complies with the following conditions:

(a) The UDF retains overall responsibility for the investment operation including subsequent monitoring of the contributions from the operational programme according to the funding agreement;

(b) The expenditure paid by such private or public entities is reported formally to the UDF which is responsible for verifying the reality and eligibility of the expenditure claimed; and

(c) The audit trail is maintained down to the level of the payment of private/public co-financing to the final recipient UDP.

2.7.5. Investment process

(136) The UDF manager is responsible for making commercial decisions within the agreed investment strategy regarding the UDF funds invested into individual UDPs.

2.7.5.1. Identification of potential UDPs

(137) The measure is a demand-driven instrument where investments are made in principle on a “first come, first served" basis.

(138) After signing operational agreements with UDF managers, a marketing campaign will be undertaken in order to attract UDPs. The UDF will identify potential UDPs through an open call for projects. To that end, a website for the JHFB has been created by the Bulgarian authorities where information and indications for potential UDP promoters is included.[38]

2.7.5.2. Investment appraisal and commercial investment decisions

(139) The UDF manager is contractually obliged to assess the creditworthiness of each UDP using criteria and processes that are in line with international investment management practices and in line with the UDF's investment policy as well as use all reasonable efforts to ensure optimal investment exits from UDPs. Failure to comply with those management duties would constitute a breach of the managing contract.

[38] http://www.bgregio.eu/jessica.aspx

(140) The UDF takes commercial risk on the success of the UDPs, as its investments will be repaid through debt service or equity remunerated through investment exit. Therefore, the UDFs will invest only in projects that are technically and – together with the UDF investment - economically viable (see the requirement above).

(141) For any form of investment, the UDFs will carry out investment appraisal of estimated investment performance based on the Discounted Cash Flow (DCF) method. They will assess investment costs, operating costs and revenues throughout the project cycle in order to determine the financial return on investment through the following indicators that measure the capacity of the net revenues to remunerate the investment cost of equity: the financial net present value of the project (NPV)[39] and financial internal rate of return (IRR).[40]

(142) Following standard investment appraisal practice, cash flow forecasts will be estimated for a certain time frame, typically between five and ten years, unless the specific features of an UDP require a longer investment horizon.

2.7.5.3. Necessity test

(143) The UDFs may provide sub-commercial debt, guarantees or equity at sub-commercial terms to UDPs only when a project is unable to secure the necessary equity or debt finance to start the project due to market failures or socio-economic deprivation mentioned in sections 2.1.5 and 2.1.6. As part of the application to the UDF, the UDP promoter must demonstrate to the satisfaction of the UDF manager that, prior to applying for sub-commercial conditions under the measure, reasonable efforts were taken to secure the maximum level of private finance under market conditions. It must present estimates of the project viability with and without UDF investment, demonstrating that the profitability of the project is insufficient to obtain funds at market conditions and that UDF sub-commercial investment is needed.

(144) The UDF managers are responsible for the precise identification and record-keeping of alleged market failures or socio-economic factors that affect project's viability. Where the UDF manager also acts as a co-investor, the assessment will be carried out by an Independent Expert in order to avoid possible conflicts of interest. For further details on Independent experts section see 2.7.6.2.

(145) For UDF investment in already started (but not yet completed) UDPs, the UDF managers will need to verify that its investment will have one or more of the following effects on a specific project:

(a) A substantial increase of the project/activity size arising from the aid;

(b) A substantial increase of project/activity geographical scope arising from the aid;

(c) A substantial increase of the project/activity amount invested by the beneficiary arising from the aid;

(d) A substantial increase of the project/activity execution speed arising from the aid.

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[39] The NPV is defined as the difference between the expected revenues and costs discounted with a suitable discount rate, i. e. a risk adjusted cost of capital.

[40] The IRR is defined as the discount rate that produces a zero NPV.

2.7.5.4. Investment structuring: limiting preferential conditions for private UDP partners to a Fair Rate or Return

(146) Detailed terms and conditions for financing to be provided by an UDF must be determined prior to making an investment for each UDP on the basis of financial forecasts prepared for that UDP and verified by an UDF. Financial criteria will differ according to the projects and financial products selected by the UDF (loans, guarantees, equity) and will be established by a UDF manager on a case-by-case basis. Those criteria may include: internal rate of return, net present value, pay-back period, cash flow profile, availability and form of collateral (if required) and other financial indicators typically used in credit analysis.

(147) According to the Bulgarian authorities, UDF investments will be limited to the minimum necessary to make UDPs commercially viable for project promoters to undertake investment activities and market investors to provide additional funding. It is to be understood that as an overall principle, in order to limit the aid to the minimum amount necessary for the particular UDP, UDF equity, guarantees and loans at sub-commercial conditions may only improve expected returns for market investors at the UDP level up to a Fair Rate of Return (FRR), equivalent to a risk-adjusted discount rate which reflects the level of risk of the project and the nature and level of capital the private investors plan to invest.

(148) The FRR is to be understood as the hurdle rate set *ex-ante* up to which the private project promoter will benefit from preferential *non-pari-passu* conditions in case of successful exit from UDP. The FRR is therefore never guaranteed to the private UDP partner. Given the risk of UDP failure, the FRR mechanism will result in an average profitability for UDPs after exit which is likely to be significantly below the FRR.

2.7.6. Establishing the Fair Rate of Return (FRR)

2.7.6.1. Preferable option: a competitive process to establish FRR

(149) The preferred approach to establish the FRR for investors in a specific UDP is to run a competitive process among potential investors. Where such a competitive process has been followed, the resulting rates agreed for investors would then constitute the FRR.

(150) For cases where there is no EU or national legal obligation to launch a formal public procurement, competition is ensured by the UDF manager through a transparent, open and non-discriminatory selection process, addressed to any interested parties, followed by appropriate negotiations with potential investors.

(151) An appropriate competitive process will involve negotiations with at least two potential investors. Evidence of that process will be recorded by the UDF manager.

2.7.6.2. Second option: use of Independent Experts in non-competitive scenarios

(152) While a properly conducted competitive process would always be the preferred way of establishing the FRR, it cannot be applied in all cases due to the characteristics of project financing. Competition may not always be an option e.g. in case where the potential private investor is the owner or concessionaire of the site/building to be

developed and therefore the requirement concerning the tender cannot be met. Where the scope of the competitive process is limited or non-existent, the FRR will be determined by an Independent Expert on the basis of a professional analysis of industrial benchmarks and market risk using the discounted cash flow valuation method.

Methodology for establishing the FRR by the Independent Expert

(153) In case an Independent Expert is engaged by the UDF to assess the FRR for private investors, the Independent Expert's report will be based on a standardized methodology.

(154) Review of Industry Benchmarks: The starting point of the process of ascertaining the FRR will be a review of comparative data as to the returns currently expected on similar projects or regeneration investments in the market place. The Independent Expert will pool various sources of information and collate the most relevant data for each particular project or fund.

(155) In certain cases such data might not be publicly or readily available. Therefore, the Independent Expert will be allowed to draw upon its own past and recent experience of involvement in other projects or financings. The FRR report should specify which benchmarks have been referred to, and how those benchmarks have been taken into account.

(156) Review of UDP risk: That part of the assessment will have similarities with the credit committee / credit risk assessment processes in place in banks as part of loan approval.

(157) The project risk review will include, among other elements:

(a) Construction cost risk, including also inflation and exceptional factors;

(b) Planning risk;

(c) Demand risk (including impact of the geographic location);

(d) Economic environment and funding climate;

(e) Complexity of project;

(f) Competence of project sponsor and ability to deliver the project in time and within budget;

(g) Financial analysis - it should include sensitivity analysis on the project's financial model;

(h) Project sponsor's cost of finance;

(i) Security of other funding streams;

(j) Appropriateness of contingencies;

(k) Extent to which assets are pledged as debt security (equity as a percentage of project value).

(158) Calculation of FRR by an Independent Expert: Having assessed relevant Industry Benchmarks and specific risks, the FRR should then be assessed, starting with the minimum level of FRR and adding on the appropriate margin to reflect project risk.

Selection of Independent Experts

(159) The Bulgarian authorities pointed out that the mission of the Independent Expert is of great importance for the success of the measure. It requires industry and market knowledge as well as financial expertise, both related to the investment policy and strategy in the particular type of project.

(160) Independent Experts will need to comply with deontological and professional rules issued by the relevant professional associations in order to ensure independence and professional behaviour of its members. Professional associations have to enjoy supervisory powers and may impose sanctions on its members. In exceptional cases where matters are not covered by official qualifications and professional rules, experts must be appointed among persons with a proven expertise in the subject.

(161) The choice of eligible Independent Experts would depend on the type of eligible Urban Project to be financed and the sector and geographical area in which the concerned project will take place. Generally speaking, Independent Experts may fall in the following categories:

(a) Professional Service Firms, such as accounting firms;

(b) Property Firms, such as chartered surveyors or real estate development consultants;

(c) Investment banks carrying out advisory work;

(d) Specialist consultancies involved in public private investment funds and project finance.

(162) In order to facilitate the identification of appropriate Independent Experts and as a safeguard to prevent risks of collusion, the JFHB will carry out an open pre-qualification and pre-selection procedure at national level resulting in a list of eligible Independent experts from which UDFs would appoint individual Independent Experts for specific projects.

(163) The JFHB will also provide UDFs with a contract template to be used when appointing an Independent Expert. In that template it will be stated that the Independent Expert is liable for the accuracy of its expertise not only to the UDF but also to the JHFB.

Ensuring independence of Experts

(164) Independence of Experts from the UDF will be crucial and any potential candidate will be required to ensure the absence of any potential conflict of interest for each UDP. Accordingly:

(a) The Independent Expert shall disclose all current relationships with the UDF or the candidate investor at the time at which its mandate is entered into.

(b) If the Independent Expert is a legal person, no capital links shall exist between the Independent Expert and the UDF or the candidate investor offered to co-finance a UDP.

(c) During the term of the mandate, the Independent Expert shall undertake not to create a conflict of interest by having or accepting employment or appointment as a member of the board of the UDF or the candidate co-investor, or by having or accepting any assignments or other financial interests in the UDF or the candidate investor.

(d) If the Independent Expert becomes aware of a potential conflict of interest during the mandate, the Independent Expert will be obliged to notify the UDF and/or the MA and resolve the problem immediately. If the conflict of interest cannot subsequently be resolved, the UDF and/or the MA will be entitled to require the termination of the Independent Expert mandate.

(165) The rules concerning conflicts of interests will apply to the Independent Expert itself, members of its team, their spouses and the Independent Expert's Partner Firms, meaning members of the same group of companies or organisation.

(166) An UDF shall not use the same Independent Expert more than twice within a period of six months.

2.7.6.3. Monitoring and accounting of UDFs

(167) For compliance with the monitoring and reporting requirements on the implementation of investments, UDFs will contribute to the monitoring system of the Holding Fund.

(168) Annual reporting will provide a detailed analysis on the execution of the operations carried out during the year, and will contain an analysis of the implementation of the investment and planning strategy as well as detailed information on the progress of the UDPs.

(169) The JHFB will be entitled to realize a monitoring and active follow-up of the projects, mainly towards the UDFs, but also and if necessary to the UDP themselves, with the purpose to verify the accuracy and veracity of the referred information, the transparency of the selection process, and to ensure that funds are invested in compliance with the Bulgarian OPRD.

(170) In case of irregularities, the UDF and the JHFB will actively collaborate with a view to solving them. It may include all measures aiming at obtaining a payback of the financing; inter alia the exclusion of the UDP from financing or its replacement by another UDP. The JHFB will report the irregularities to be processed to the Bulgarian authorities.

(171) Representatives of the European Commission, the European Union Court of Auditors, the Holding Funds, the Bulgarian authorities or any other institutions properly empowered by law to realize audit and control will have constant access to the documents of the UDF, with a view to obtain guarantees on the legality and regularity of the financial contribution.

(172) The UDF will establish fiscal controls and accounting procedures conforming to international accounting principles.

2.7.6.4. Treasury management of the UDF

(173) The use of interests and other gains generated by payments from the JHFB as well as the use of returns, resources returned to funds and returns from investments at the level of final recipients, will comply with Article 78(7) of the General Regulation and Article 43(5) of the Implementing Regulation. The interest rate applicable on available funds (funds transferred to the UDF and not yet invested in UDPs) will be in line with market rates.

2.7.6.5. Winding up provisions of the UDF

(174) Resources returned to the UDF – even after the liquidation of the UDF – must be used for sustainable urban development in line with Article 78(7) of the General Regulation. Returned resources will be reemployed in the area targeted by the OPRD Bulgaria through repayable instruments, with a view to ensuring further multiplication and recycling of public money. It does not apply to the resources of private investors, which can be returned to them after the completion of the project.

2.8. Cumulation and applicability of other EU legislation

(175) Notwithstanding limitations in existing EU State aid legislation, aid provided under the measure can be granted together with other State aid as long as the latter is taken into account when structuring investment conditions and notably when calculating the appropriate FRR.

(176) Once investment conditions including the relevant FRR under the current measure are fixed, no additional State aid can be granted.

(177) In cases of investments aimed at repairing environmental damage (e.g. land decontamination), the "polluter pays" principle will be respected. Therefore no aid should be provided if there is a private entity responsible for the pollution of a contaminated brownfield or greenfield[41] and it is still legally possible for that entity to repair and compensate the consequences of the pollution.

(178) In case of investments in the field of transport, the notification is without prejudice to legally binding EU legislation.

2.9. Monitoring, Record Keeping, Individual Notification and Standardized Information Sheets (SIS)

(179) Notwithstanding additional obligations under Structural Funds rules, an annual report on the expenditure under this scheme, allowing assessment of compliance with State aid rules, will be provided to the Commission.

(180) For compliance with State aid requirements, records will be kept for ten years from the date of the last award of aid under the scheme. Records will be sufficiently detailed to establish that the conditions of the scheme are met, to include confirmation of the beneficiaries' status and eligibility of supported costs.

(181) If the Commission requests information necessary for it to assess whether the State aid conditions have been complied with, the Managing Authority will provide it within the agreed time period.

(182) The Bulgarian authorities have agreed to notify individually, for approval by the Commission, aided major projects exceeding an overall volume of EUR 50 million, irrespective of the proportion of those costs financed by the UDF. This obligation is

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41 By entity or person responsible for the pollution is meant the person liable under the law applicable in each Member State, without prejudice to the application of European Union rules in the matter, such as Directive 2004/35/EC of the European parliament and the Council of 21 April 2004 on environmental liability with regard to the prevention and remedying of environmental damage (OJ L 143, 30.4. 2004, p. 56).

without prejudice to the provisions of the *de minimis* Regulation[42], setting conditions for the absence of State aid under certain circumstances.

(183) The Bulgarian authorities will provide a Standardised Information Sheet (SIS) for each sub-commercial UDF public investment exceeding EUR 5 million in a single project. The format of the SIS will be agreed between the Bulgarian authorities and Commission services. The Commission will not approve each SIS as a condition for making investments.

3. ASSESSMENT

3.1. Presence of State aid pursuant to Article 107(1) TFEU

(184) In order for a measure to constitute State aid within the meaning of Article 107(1) TFEU it has to fulfil four conditions. Firstly, the aid is granted by Member State or through State resources. Secondly, the measure confers a selective advantage to certain undertakings or the production of certain goods. Thirdly, the measure is liable to affect trade between Member States. Fourthly, the measure distorts or threatens to distort competition in the internal market.

3.1.1. Types of State resources

(185) The measure's initial budget is composed of resources from the ERDF as well as national match funding and therefore entirely qualifies as State resources.

(186) Additional public in-kind contributions (e.g. land or buildings at the UDF and/or project level) will also constitute State resources.

3.1.2. Advantage: Levels of assessment

(187) Under the measure, State resources will typically be transferred to the JHFB and further on to UDFs that will invest those resources together with private co-investors in UDPs, where they will be used to provide for goods and services such as construction of buildings required for physical project delivery.

(188) To verify whether an undertaking has benefited from an economic advantage, the Commission applies the criterion of the ‘market economy investor principle’. The assessment makes no distinction between the different types of beneficiaries in terms of their legal structure or ownership (public or private). The principles of non-discrimination and equality do not exempt public authorities or public companies from complying with EU competition rules.

(189) The investment of capital or provision of loans by the State is considered State aid within the meaning of Article 107(1) TFEU, if the funds would not have been provided by a private undertaking under the same market conditions. This is considered to be the case if the (monetary) compensation that the State receives in exchange for the loan or equity investments is lower than what a private investor would have required in the circumstances.

42 Commission Regulation (EC) No 1998/2006 of 15 December 2006 on the application of Articles 87 and 88 of the Treaty to *de minimis* aid (OJ L 379, 28.12.2006, p.5).

(190) However, the Commission will consider the investment not to constitute State aid in a situation where the investments are effected pari-passu between public and private investors and public and private investors share exactly the same upside and downside risks and rewards and hold the same level of subordination, and normally where at least 50 percent of the funding is provided by private investors that are independent from the companies in which they invest.

(191) Similar to Commission's considerations on potential State aid at various levels under point 3.2 of the Community Guidelines on State Aid to promote Risk Capital Investments in Small and Medium-Sized Enterprises (RCG)[43], the Commission has assessed the existence of a selective advantage at several levels.

3.1.2.1. Advantage at the level of the Holding Fund and/or its management

(192) As pointed out under the fifth paragraph of point 3.2 of the RCG, the Commission in general considers that an investment fund is an intermediary vehicle for the transfer of resources rather than a beneficiary of aid itself. Applying that consideration to the present notification, the Commission finds that no State aid within the meaning of Article 107 (1) TFEU is granted to the Holding Fund.

(193) With regard to the Holding Fund's management, the Commission has taken note that, as pointed out above, the EIB has been entrusted with the management in line with applicable EU provisions, including the foreseen remuneration cap of […]% of the funds administered. The HF management is therefore not receiving State aid within the meaning of Article 107(1) TFEU.

3.1.2.2. Advantage at the level of an UDF and/or its management.

(194) As regards potential State aid at the level of the UDF, the Commission finds that, based on the same arguments as stated in recital (192) with regard to the Holding Fund, no State aid within the meaning of Article 107(1) TFEU is present.

(195) As far as the UDF management is concerned, the Commission has assessed whether under the measure a remuneration arrangement for management of UDF resources might be established that entails a management fee higher than under normal market rules thus comprising State aid. As pointed out above in recital (81), the selection of management for UDFs under the notified measure is carried out by means of open tender. The remuneration, while capped at 3% p.a. of administered resources, is therefore subject to negotiations between the Holding Fund and candidates for UDF management. Given the number of potential applicants for UDF management, the Commission finds that the tendering procedure will result in a level of remuneration for the UDF management that is in line with market rules and no State aid within the meaning of Article 107(1) TFEU will be provided to the UDF managers.

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[43] OJ C 194, 18.8.2006, p. 2.

3.1.2.3. Advantage at the level of private co-investors and project promoters

(196) Private investors can invest their resources at the level of an individual project together with resources managed by the UDF. They can invest money or contribute in kind, e.g. land owners contributing their land into a UDP in exchange for a share of potential profits or losses incurred in that project. As pointed out above, private investors can, following the procedure for establishing a FRR, benefit from investment conditions that are more favourable than those entered into by the UDF. The latter accepts a compensation lower than a private investor would have required in the same market conditions. Therefore, private investors can carry out investments on terms more favourable than public investors, or on terms that the market would not offer in the absence of the measure. For example, private investors may benefit from higher profit options in comparison to the public investment carried out by the UDF or the UDF may accept to incur a higher risk of losses on its investment. Moreover, preferential conditions can be granted to the private investor through sub-commercial loans of the UDF.

(197) In any of the scenarios described above, private investors will be in a position that is economically advantageous compared with normal market conditions in the absence of State intervention, where co-investment would normally be carried out at identical, *pari-passu* conditions for all investors and no sub-commercial loans would be available. While in some specific cases the advantages granted might correspond to specific additional economic burdens that the private investor accepted, such as provision of publicly available infrastructure, there will also be a significant number of cases where the UDF will provide advantageous investment conditions simply in order to increase economic viability in a project facilitating sustainable urban development.

(198) The Commission has also assessed, whether the establishment of the FRR by a competitive process or by using an Independent Expert respectively will exclude the existence of a selective advantage within the meaning of Article 107(1) TFEU. However, given the numerous eligibility criteria for UDPs as well as the UDF manager's discretion when choosing and structuring projects, the Commission has concluded that the provision of preferential investment conditions will normally confer a selective advantage to private investors under the measure.

(199) As a result, the Commission concludes that private investors under the measure can receive an advantage within the meaning of Article 107(1) TFEU.

3.1.2.4. Advantage at the level of UDPs

(200) While UDPs can have the form of a block of finance that is sufficiently transparent for monitoring and auditing purposes, UDPs might also constitute a legal entity of their own. In that case, UDPs can be recipients of State aid provided all conditions in Article 107(1) TFEU are met. The Commission thus finds that under the notified measures, UDPs can receive an advantage within the meaning of Article 107(1) TFEU.

3.1.2.5. Effect on Trade and Potential Threat to Competition

(201) Under the measure, as pointed out above, private co-investors as well as UDPs themselves can benefit from a selective advantage. The undertakings in question, among

them project developers and possibly financial institutions, will be active in markets open to competition and in many cases subject to intra-Union trade. The measure therefore has an effect on trade and poses a potential threat to competition.

(202) In the light of the foregoing, the Commission finds that the notified measure contains State aid within the meaning of Article 107(1) TFEU.

3.2. Notification of aid

(203) In notifying the current measure prior to implementation, the Bulgarian authorities complied with the obligation in Article 108(3) TFEU.

4. COMPATIBILITY ASSESSMENT

4.1. Applicability of existing State aid provisions

(204) Prior to considering a JESSICA specific assessment directly under Article 107(3)(c) TFEU, the Commission had to verify whether the notified scheme falls within the scope of existing secondary State aid provisions. Given the large variety of UDPs to be funded under the notified measure, the Commission has limited that verification to a number of horizontal rules which in principle apply across all industries.

4.1.1. Applicability of EU rules on the provision of Services of General Economic Interest (SGEI)

(205) The Commission has assessed applicability of EU rules on the provision of SGEIs pursuant to the European Union framework for State aid in the form of public service compensation (hereinafter the "SGEI Framework")[44] and the Commission Decision of 20 December 2011 on the application of Article 106(2) of the TFEU to State aid in the form of public service compensation granted to certain undertakings entrusted with the operation of services of general economic interest (hereinafter the "SGEI Decision").[45] While these provisions have not been invoked by the Bulgarian authorities and their specific requirements therefore have not been addressed in the notification, some of the possible UDPs (e.g. creation of social housing) might fall within the applicability of SGEI rules. It is in particular worth noting that one of the key principles inherent to SGEI rules (avoiding overcompensation) shows similarities with the mechanisms under the current measure in order to limit the granting of advantages to private investors.

(206) However, a significant number of potential UDPs, such as the creation or refurbishment of shopping centres or hotels as well as the creation of office space will most likely fail to meet the wide definition of SGEI under point 2.2. of the SGEI Framework. Furthermore, it is not sufficiently sure that the selection of UDPs by UDFs in cooperation with the JHFB would, despite the large discretion involved in the process, fulfil the conditions for entrustment by a Member State laid down in Article 4 of the SGEI decision.

(207) It follows that EU rules on the provision of SGEI are not applicable to the notified measure.

[44] OJ C 8, 11.01.2012, p. 15.
[45] OJ L 7, 11.01.2012, p. 3.

4.1.2. Applicability of the Guidelines on national Regional Aid for 2007-2013 (RAG)[46]

(208) When assessing the applicability of the RAG, Commission has taken note that, while Bulgaria is in principle eligible for national Regional Aid under the current Bulgarian Regional Aid Map,[47] the notified measure does not comply with a number of provisions on aid ceilings and eligible expenditures laid down under point 4.1.2. of the RAG. On the contrary, the notified measure does not provide for fixed maximum amounts of aid, but lays down rather general limitation criteria reflecting the asymmetric sharing of investment risks and options.

(209) As a result, the Commission finds that the notified measure does not fall within the scope of the RAG.

4.1.3. Applicability of the Community Guidelines on State aid to promote Risk Capital Investments in Small and Medium-Sized Enterprises (RCG)[48]

(210) As regards the applicability of the RCG, Commission has taken note that the funding structure involving investment funds as well as joint public-private investments at preferential terms for private investors present some analogies with the set-up foreseen in point 3 of the RCG.

(211) At the same time, the RCG stipulate a series of requirements (e.g. maximum joint public private investments of EUR 2.5 million for standard assessment and general restriction to SMEs as target enterprises) that will not be met by all possible UDPs under the measure. Moreover, the notified measure includes the significant additional element of addressing integrated sustainable urban development. Furthermore, the current measure provides for fine-tuned mechanisms aimed at limiting the advantages granted to private investors, whereas the RCG provides hardly any such limitations[49] and rather relies on safe-harbour clauses concerning investment amounts.

(212) In the light of the above, the Commission concludes that only smaller projects under the notified scheme could be covered by the RCG. The Commission therefore finds that the RCG do not prevent an assessment of the notified measure directly under Article 107(3) c) TFEU.

4.2. Conclusion

(213) As pointed out above, none of the existing State aid provisions is applicable to all UDPs which can be possibly supported under the notified measure. It follows that no existing secondary State aid legislation would provide UDFs with an uniform set of compatibility conditions for State aid compliance. At the same time, no current legislation fully reflects the integrated approach to fostering sustainable urban development projects of the scheme notified by the Bulgarian authorities.

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46 OJ C 54, 4.3.2006, p.13.

47 OJ C 73, 30.3.2007, p.15.

48 OJ C 194, 18.8.2006, p. 2.

49 The upper limit for loss limitation to 50% of the private contribution as stipulated under point 4.2.(b)of the RCG being the only explicit exception.

(214) The Commission therefore finds that no existing EU legislation prevents the notified measure from being assessed directly under Article 107(3)(c) TFEU.

4.3. Assessment under Article 107(3) c) TFEU

(215) Taking into account that no specific secondary EU legislation appears directly applicable, the Commission has examined whether the measure could be approved on the basis of Article 107(3)(c) TFEU, which stipulates that *'aid to facilitate the development of certain economic activities or of certain economic areas, where such aid does not adversely affect trading conditions to an extent contrary to the common interest'* may be considered to be compatible with the Internal Market.

(216) In examining the compatibility directly under Article 107(3)(c) TFEU, the Commission has carried out a detailed economic assessment to evaluate its positive and negative effects. The Commission takes into account whether the aid measure is aimed at a well-defined common interest objective, is an appropriate instrument, is well targeted and proportionate to the targeted objective and does not adversely affect trading conditions to an extent contrary to the common interest. Positive and negative aspects are balanced against each other.

4.3.1. Targeting an objective of common European interest

(217) State aid may be authorised by the Commission if it contributes to the achievement of one or more of the objectives of common interest identified in Article 107(3) TFEU. Whether a measure contributes to an objective of common interest can be understood in terms of its contribution to efficiency or equity.

(218) As pointed out above in section 2.1, the measure aims at facilitating sustainable urban development by providing sub-commercial conditions to private investors with a view to achieving greater market efficiency or equity objectives.

(219) The Commission notes that the Bulgarian authorities correctly refer, as pointed out in section 2.1.2, to Structural Funds rules, underlining the importance of sustainable urban development in order to increase market efficiency and social cohesion.

(220) Also in previous decisions, the Commission has considered that the physical, economic and social regeneration of urban areas is clearly a European objective[50].

(221) The Commission therefore finds that the notified measure targets an objective of common European interest.

4.3.2. Appropriateness

(222) The Commission must examine whether the measure is an appropriate policy instrument to support sustainable urban development in Bulgaria. In this context, the Commission takes into account whether there are measures that are better suited to overcome market failures and foster socio-economic cohesion.

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50 European Commission (2009), decision N555/2008, Centrumplan gemeente Mill en St. Hubert, OJ C 294, 3.12.2009 p. 1 rec. 48; European Commission (2011), decisions SA.32835 (2011/N) - United Kingdom – The Northwest Investment Fund (Jessica) OJ C 281, 24.9.2011, p. 7 and SA.32147 (2011/N) – Spain - Jessica Holding Fund Andalucía, OJ C 79, 17.3.2012, p. 1.

(223) Member States can make different choices with regard to policy instruments and State aid control does not impose a single way to intervene in the economy. However, State aid falling under Article 107(1) TFEU must be justified by the appropriateness of that particular instrument of State intervention to meet a well-defined public policy objective and contribute to one or more objectives of common European interest.[51]

(224) The Commission will consider a measure to constitute an appropriate instrument where the Member State has considered policy options equally suitable to achieve a given objective of common European interest, including measures less distortive to competition than the selective grant of State aid, and where the Member State can demonstrate to the Commission that the measure is suitable in view of achieving the relevant efficiency or equity objectives.

4.3.2.1. Consideration of other policy options less distortive to competition

(225) Traditionally, urban development and regeneration projects, including infrastructure development projects, have been structured around types of activity involving public and private sectors with clearly delineated roles. While the public sector traditionally undertook the role of acquiring and assembling land, addressing the need for site clearance, remediation and the provision or improvement of large-scale infrastructure and the public realm, the private sector has traditionally focused on commercial development.

(226) Due to the pressures facing government budget, public authorities are no longer in a position to provide the necessary funding required for addressing urban development needs. Therefore, private capital is needed to provide financing of urban investment projects, which means that projects must be commercially viable to remunerate market investors and service the debt. In that respect, public funds can act as a catalyst to leverage additional funding to finance urban investments.

(227) As pointed out above in recital (21), in the past the Bulgarian authorities have used different measures in order to address urban development, namely grant funding to public authorities such as municipalities with no undertakings involved.

(228) Those policy options differed significantly from the current approach under the JESSICA Bulgaria scheme which is designed to provide new opportunities for urban development by the following means:

(a) Ensuring long-term sustainability through the revolving character of the funds invested in UDPs;

(b) Creating stronger incentives for successful implementation of UDPs by beneficiaries, by combining grants with loans and other financial instruments;

(c) Leveraging additional resources for UDPs with a focus on their sustainability and recyclability in the target area; and

(d) Contributing financial and managerial expertise from specialist institutions to UDPs.

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51 See for a discussion of appropriateness cases C 25 / 2004 - DVB-T Berlin-Brandenburg (OJ L 200, 22.07.2006) or N 854 / 2006 - Soutien de l'agence de l'innovation industrielle en faveur du programme mobilisateur pour l'innovation industrielle TVMSL, OJ C 182, 04.08.2007.

(229) When assessing whether the Bulgarian authorities have considered alternative and less distortive options equally suitable to achieve the common European interest objective, the Commission has taken into account that the notified measure includes numerous components aimed at maximising the participation of private investment and professional expertise, while at the same time limiting State aid to a minimum through of the application of the FRR criterion in combination with commercial management of UDFs.

(230) As a result, the Commission concludes that the Member State did not fail to consider alternative options as suitable to achieve the common interest goal but less distortive to competition.

4.3.2.2. Measure's suitability to address efficiency objectives

Existence of market failures

(231) As pointed out above in section 2.1.5, the Bulgarian authorities provided the Commission with evidence of possible market failures in the context of UDPs in Bulgaria. In addition, the claimed existence of a market failure will be duly verified and recorded prior to any UDF investment into specific UDPs.

Addressing market failures with JESSICA Bulgaria

(232) In order to assess the measure's appropriateness, the Commission has also assessed whether the identified market failures will be properly addressed by the instruments foreseen under the notified measure.

Addressing market failures due to externalities

(233) By ensuring that regeneration projects are sustainable and integrated in their approach and are part of a broader plan for the area, the measure will create long-term value and help address investors' negative perceptions of regeneration areas.

(234) The interventions carried out under the measure will lead to the internalisation of the positive externalities generated by those components of an integrated urban plan that produce no or insufficient revenues for private investors, such as the improvement of public spaces or other public good components.

(235) As regards problems due to negative externalities such as pollution, by favouring, for example, the installation of solar panels, the notified measure enables UDF managers to grant favourable investment conditions in order to attract private investment to projects addressing renewable energy solutions, that otherwise, without the public support, may have been abandoned by the private investor.

Addressing market failures due to information failures and risk aversion

(236) By ensuring that regeneration projects are sustainable and integrated in their approach and are part of a broader plan for the area, the measure will create long-term value and help address investors' negative perceptions of regeneration areas.

(237) Furthermore, by providing for professional project appraisal, the notified measure ensures that selected UDPs are feasible from an economic, social and technical point of view and comply with the eligibility criteria in the relevant regulations. In that context,

the analysis of the financial structure, risk profile and the expected revenues for the different stakeholders makes investment decisions more transparent and therefore more reliable.

(238) In addition, the portfolio approach developed in the financing of UDPs ensures greater long-term investment opportunities and a diversification of the financial risk.

Addressing market failures due to coordination problems, transaction and agency costs

(239) By centralising and internalising project appraisal, transaction and agency costs, project participants can benefit from economies of scale.

Conclusion as to the measure's suitability to address efficiency objectives

(240) In the light of the above, the Commission concludes that the measure is suitable to tackle the identified market failures, thus addressing efficiency objectives.

4.3.2.3. Measure's suitability to address equity objectives

(241) When considering the measure's suitability to address equity objectives, the Commission notes that the Bulgarian authorities, as stated in section 2.1.6, can underpin the identified need to tackle socio-economic problems in deprived urban areas both by reference to general EU documents as well as to scientific publications for Bulgaria. In addition, Bulgaria correctly refers to the Operational Programme 2007-2013 that covers measures to tackle socio-economic issues. The Commission therefore finds that the need for tackling socio-economic problems in deprived urban areas of Bulgaria is sufficiently explained.

(242) Moreover, the Commission has taken note that, as pointed out in recital (116), every UDP must comply with the SF Regulations and in addition contributes to the objectives defined in the relevant IPSUD and Bulgaria OP, including the quantitative outputs stipulated in the latter.

(243) The Commission concludes therefore that the measure is suitable to address equity objectives.

4.4. Incentive effect

(244) The existence of a market failure or a cohesion objective is a *necessary* but not sufficient condition for granting State aid. State aid must be effective, i.e. have an incentive effect. The measure at issue contains sufficient safeguards aimed at ensuring this condition is fulfilled in all UDPs concerned.

4.4.1. Application for UDF investment prior to the start of a project

(245) State aid will only be considered to have an incentive effect if, before starting a project or activities, the beneficiary submitted an application for the aid, i.e. submitted an application for UDF funding. That condition is fulfilled in the present case.

4.4.2. *Necessity test for every UDP*

(246) Due to the nature of the investment or characteristics of deprived urban areas, the investment would not have been implemented by the market on its own because of the fairly low expected financial return and the relatively high risk of investing in the area. The necessity test essentially shows that projects of the same nature, i.e. with an IRR below the FRR, would not be carried out by the market (a counter-factual scenario) or, at least, the investments would not take place to the same extent and in the same timeframe.

(247) Moreover, UDF managers will carry out an investment appraisal for each project and will examine technical quality and economic and financial viability. In the context of that exercise, they will duly establish a viability gap to justify any finding that the market would not proceed on its own.

(248) The Commission finds therefore that the measure's incentive effect is sufficiently demonstrated.

4.5. Proportionality

(249) State aid must be proportionate in relation to the legitimate objective in order to be compatible with the internal market. The Commission must therefore examine whether State aid granted to project developers and other private investors at the UDF or project level is proportionate to securing their participation. The aid is considered to be proportionate only if the same result could not be reached with less aid and less distortion.

4.5.1. *Commercial management and success-based remuneration*

(250) When it comes to assessing the measure's proportionality, i.e. whether mechanisms are in place to minimize State aid granted under the measure to a minimum, the Commission has paid particular attention to those parts of the measure that enhance decision-making in line with commercial logic.

(251) In that context, the Commission has noted that under the measure, investments entered into by UDFs, while potentially granting sub-commercial conditions to private investors, are selected and structured by professional and independent fund managers that have been chosen in an transparent process. The Commission finds that the selection of professional fund managers adds to the likelihood of economically sound investment decisions with limited deviations from market rules.

(252) The Commission also notes that in addition to the selection of professional management, the remuneration system as explained above in section 2.6.3.2 foresees a variable part which is subject to overall fund performance. It will normally encourage UDF managers to limit granting of sub-commercial conditions to co-investors because any such grants will at the same time reduce the management's remuneration.

(253) In addition, management requirements such as the existence of a business plan including an exit strategy and the governance structures including reporting obligations to the JHFB will further improve the commercial soundness of the UDF management.

4.5.2. *Required repayment of initial investments*

(254) As pointed out above in recital (117), UDFs can only invest in UDPs whose business plan foresees the full repayment of UDF investment. The Commission considers that "zero floor" requirement a suitable tool to ensure a minimum economic viability of selected projects and, at the same time, a transparent means to exclude excessive deviation from market rules.

4.5.3. *Private participation*

(255) The notified measure foresees, as explained in section 2.7.4, a minimum participation of private investors, i.e. investors following purely profit-oriented goals in line with market logic in the form of investment at risk for every UDP. Private co-investment is a requirement that limits the use of public resources and, at the same time, ensures the benefit of market experience and professionalism in joint investment projects. In addition, the requirement for any UDF investment to find a private investor willing to put his own investment at risk increases the economic soundness of funded projects significantly.

4.5.4. *Limiting preferential investment conditions for private investors*

(256) When weighing the effect that private participation has on public investments' compliance with State aid rules, the Commission has paid special attention to advantages granted to private co-investors at the expense of public investment. While the Commission normally considers public investments carried out at identical – *pari-passu* - investment conditions with private investors to be in line with the Market Economy Investor Principle and therefore free from State aid, public-private investments with preferential conditions for the private partner can under certain circumstances constitute compatible State aid as pointed out for example in the Risk Capital Guidelines.

(257) The Commission has verified the mechanism implemented under the notified measure (see recitals (146) to (166)) in order to limit to the minimum the preferential investment conditions granted to private investors in the form of sub-commercial loan and equity up to a properly established FRR. As a result, the Commission considers that the application of the FRR criterion a suitable tool in order to avoid any over-compensation of private investors.

(258) The Commission has also noted that any profits beyond the FRR agreed beforehand between the UDF and private investors will be shared proportionally. Thus both private investors and the UDF will benefit from unforeseen project over-performance in proportion to their investment.

4.5.5. *Conclusion as to proportionality of the measure*

(259) In the light of the above, the Commission finds that the measure is proportionate.

4.6. Distortion of competition and trade

4.6.1. Relevant markets

(260) The Commission has identified several relevant markets, potentially affected by a distortion of competition due to the notified measure: the market for financial investments, for investment intermediation (asset management companies and financial institutions), as well as the market for property and infrastructure development.

4.6.2. Effects on the market

(261) The Commission has analysed the effects of the notified measure taking into account (i) the aid granting process, (ii) the characteristics of the relevant markets and (iii) the type and amount of aid when assessing the significance of the distortive effects of the measure and its effect on trade.

4.6.2.1. Long-term dynamic effects

(262) State aid may have long-term dynamic effects on the incentive to invest and compete in affected markets. In the longer run, such a change in dynamic incentives leads to less choice, and potentially to lower quality or higher prices for consumers.

(263) The Commission notes that the aid increases the supply of new commercial property on the Bulgarian market. That property will however be open to any interested end user or buyer. Besides, the current notification only covers the supply of commercial property at prices corresponding to those customarily observed for similar property in that area.

(264) The Commission considers that the aid, to the extent that it covers the UDPs' viability gap does not provide the companies undertaking the project with resources that they can use for cross-subsidizing future projects in order to distort competition and affect trade. On the contrary, regeneration efforts targeted at remedying market failures can actually unlock opportunities for commercial developments, which had previously been inhibited.

(265) Investments will be made on the basis of business plans and realistic prospects of profitability. Therefore, State aid will not be granted in markets featuring overcapacity and in declining industries, as investments will have to be repaid through efficient operations.

(266) While the absolute amount in any given UDP is not calculated, the amount of aid is in all cases limited to what is strictly necessary in order to cover a viability gap. Thus, it would not result in project promoters or financial investors obtaining significant market power as a result of the measure.

4.6.2.2. Crowding out

(267) At a more specific level, State aids may affect competition in the product market when competitors react by reducing their own sales and investment plans (crowding out).

(268) The Commission notes that State aid will be exclusively provided to unlock those projects where the market would not undertake the activities on its own. Besides, there

will be an overall increase in the level of investment activity in the markets due to the minimum private participation requirement. Thus, crowding-out effects remain unlikely.

4.6.2.3. Input markets and location

(269) State aid may affect competition in the input markets, in particular as regards the location of investments, if State aid favours the use of particular inputs. The overall effect on input markets may be negative if it discourages competitors' investment.

(270) The measure will support development activities that are predominantly of local character and for which the effects on trade are purely indirect (e.g. through input markets) and the distortion of competition and trade is most likely to be limited.

4.6.3. Conclusion as to distortion of competition and trade

(271) On the basis of the above, the Commission can therefore conclude that the aid does not distort the proper functioning of the internal market to any significant extent and does not produce significant disparities between undertakings established in different Member States or in the location of the production factors within the EU.

4.7. Cumulation

(272) As pointed out in recitals (175) and (176), the notified aid scheme contains rules in order to prevent a cumulation with State aid granted under different provisions that would result in State aid beyond the limitations foreseen in the current notification.

(273) The Commission finds that the notified measure contains appropriate provisions on cumulation with other aid.

4.8. Monitoring and reporting

(274) As pointed out above in recitals (87) and (167), substantial monitoring requirements will enable the EIB, acting as the JHFB, to verify compliance with UDF investment rules that also result in compliance with State aid provisions including this decision. In addition, as explained in section 2.9, exhaustive monitoring requirements and reporting obligations will provide Commission with sufficient information to verify compliance with State aid rules.

(275) Simplified information sheets for UDPs above EUR 5 million of sub-commercial UDF investment and individual notification for UDPs above EUR 50 million irrespective of the proportion of that amount financed by the UDF will further enhance transparency for the Commission services.

4.9. Balancing test

(276) In order to decide about the measure's compatibility with the internal market, the Commission had to weigh its contribution to common European objectives against a possible distortion of competition.

(277) In addressing lack of efficiency in the form of market failures as well as socio-economic problems in the context of Sustainable Urban Development, the scheme thrives to reach a common European objective of great importance.

(278) The common European objective of great importance mentioned above will be achieved by a minimum public intervention. It will be ensured by means of professionally managed financial engineering instruments, providing sub-commercial investment conditions resulting from either a competitive selection process or impartially established industry benchmarks to private investors who will in exchange leverage public investment. Compared to grant funding, the aid amount will be particularly low. As far as market distortion is concerned, the requirement of in-depth knowledge of local specificities will limit distortive effects of aid granted under the scheme to non-aided EU competitors, the aid therefore not being likely have significant impact on EU trade.

(279) In the light of the above, the measure's positive effects clearly outweigh any potential distortion of competition.

5. FINAL REMARKS

(280) In the light of the foregoing, the Commission has decided not to raise objections to the notified measure, because the aid can be found compatible with the internal market in accordance with Article 107(3) (c) TFEU. This decision does not prejudice the position the Commission might take on the compatibility of the relevant measure with the EU rules on free movement of services.

(281) The Commission reminds the Bulgarian authorities that, in accordance with Article 108(3) TFEU, plans to refinance, alter or change that aid have to be notified to the Commission pursuant to Commission Regulation (EC) No 794/2004 implementing Council Regulation (EC) No 659/1999 laying down detailed rules for the application of Article 93 of the EC Treaty[52].

(282) Finally, the Commission notes that Bulgaria accepts the decision to be adopted in English.

6. CONCLUSION

(283) The Commission has accordingly decided:

- to consider the aid to be compatible with the internal market in accordance with Article 107(3) (c) of the Treaty on the Functioning of the European Union.

If this letter contains confidential information which should not be disclosed to third parties, please inform the Commission within fifteen working days of the date of receipt. If the Commission does not receive a reasoned request by that deadline, you will be deemed to agree to the disclosure to third parties and to the publication of the full text of the letter in the authentic language on the Internet site: http://ec.europa.eu/competition/elojade/isef/index.cfm

Your request should be sent by registered letter or fax to:

European Commission

[52] OJ L 140, 30.4.2004, p. 1.

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Yours faithfully,
For the Commission

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